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Supreme Court of the United States

OCTOBER TERM 1976

No. 76-1538

GRAYCO LAND ESCROW, LTD. and
HAWAIIAN RANCHOS, INC.,
dba KBSF LAND CO., INC.,

Petitioners,

v.

GORDON Y.H. WONG,
Director of Taxation, State of Hawaii,
and STATE OF HAWAII,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF HAWAII

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PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF HAWAII

Petitioners GRAYCO LAND ESCROW, LTD. ("Grayco") and HAWAIIAN RANCHOS, INC., ("Hawaiian Ranchos"), pray that a writ of certiorari issue to review the judgment of the Supreme Court of the State of Hawaii entered in this cause on February 4, 1977.

OPINIONS BELOW

The opinion of the Supreme Court of the State of Hawaii ("the court below") is reported at 57 Haw. ____, 559 P.2d 264 (1977). The Tax Appeal Court of the State of Hawaii ("the trial court") did not issue an opinion. The trial court's Findings of Fact and Conclusions of Law and also its Judgment appear in the Appendix ("App.") at pages 4a and 20a.

JURISDICTION

The judgment of the court below (App. 55a) was entered on February 4, 1977, following the denial on February 1, 1977 (App. 54a) of a Petition for Rehearing (App. 45a). This Court's jurisdiction is invoked under 28 U.S.C. §1257(3).

QUESTIONS PRESENTED

1. Whether the court below, in characterizing Petitioners' interstate financing of localized land sales transactions as being purely local in nature, impermissibly denied to Petitioners the right to a fair determination of their claim that under applicable Due Process and Commerce Clause tests, apportionment of the tax on interest income from such interstate lending activity was required under the Constitution of the United States.

2. Whether lending activity, which is otherwise interstate in nature, loses its interstate character and, therefore, its protection from wholly unapportioned

local gross income taxation under the Due Process and Commerce Clauses of the United States Constitution where the lending activity involves the financing of localized land sales transactions.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Constitution of the United States

Article I, Section 8

The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations and among the several States, and with the Indian Tribes. . . .

Amendment V

No person shall . . . be deprived of life, liberty, or property, without due process of law, nor shall private property be taken for public use, without just compensation.

Hawaii Revised Statutes ("HAW. REV. STAT.") Chapter 235, Hawaii Income Tax Law, §235-27, Vol. 3 at page 450; Chapter 237, Hawaii General Excise Tax, §§237-3, 237-13 and 237-21, Vol. 3 at pages 505, 520 and 288-290, 1975 Supplement, Vol. 3.

STATEMENT OF THE CASE

Petitioner Grayco is a California corporation having a principal place of business in Pasadena, California. Although registered to do business in Hawaii, Grayco has no employees or place of business within that State. Petitioner Hawaiian Ranchos is a Delaware corporation

which had its principal offices located in Beverly Hills, California during the period in question. Petitioner Hawaiian Ranchos was licensed to do business in the State of Hawaii in its former corporate name, KBSF Land Co., Inc. By deed of trust[1] dated June 27, 1969 Hawaiian Ranchos transferred to Grayco, as trustee, a 4,002.2916 acre parcel of undeveloped land located in the Ka'u District of the County and State of Hawaii. The parties stipulated and the court below found that the conveyance in trust was required under §2814 et seq. of the California Administrative Code for the sale of subdivided land under agreement of sale to residents of the State of California. Following the establishment of the trust, Hawaiian Ranchos, acting as developer, subdivided the parcel into 1,229 three acre lots, installed utilities and laid out streets and roads. The 1,229 lots were thereafter sold through marketing programs conducted simultaneously in California and in Hawaii and by mail solicitation in other states. Individual lot sales were consumated by having the prospective purchaser fill out an offer to purchase on a printed agreement form prepared for that purpose by

[1] The trust has been amended from time to time; its essential terms, however, remain the same. Grayco, as trustee, holds title to the land, but has no beneficial interest in the trust, other than an agreed upon trustee commission. The corpus of the trust is comprised of the land sale contracts and any unsold lots. Grayco receives monthly payments from the individual purchasers at its Pasadena, California office and deposits all receipts in California banks. The funds received by Grayco are paid out immediately to the beneficiaries, who are the marketing and sales consultant, the project lenders and the developer, Hawaiian Ranchos, as residual beneficiary. The ultimate burden of the tax herein thus falls upon Hawaiian Ranchos as residual beneficiary.

Grayco. Each offer to purchase was thereafter transmitted to Grayco at its Pasadena, California offices for approval. At the time of filling out the printed sales agreement form, the prospective purchaser also received either the California or the Hawaii State Real Estate Commissioner's Report, the Report issued by the Office of Interstate Land Sales Registration, United States Department of Housing and Urban Development and a Notice of Right to Recision required under Regulation Z, Truth in Lending, 12 C.F.R. §226.1 et seq. (1976). As a result of the sales and marketing activities which took place primarily in California and Hawaii, 1,179[2] of the 1,229 lots were sold on 17 to 19 year agreements of sale[3] with interest on the unpaid principal balance at seven per cent (7%) per annum. Of these lots, 314 were sold to Hawaii domiciliaries and 865 were sold to domiciliaries of the State of California, other states of the continental United States and foreign nations.[4] For the period of December 1,

[2] A relatively small number of lots were sold outright for the total purchase price in cash.

[3] An agreement of sale is a form of contract commonly used to finance the sale of real property in Hawaii. It is a two party contract whereby the vendor agrees to sell the real property at a specified price and the vendee agrees to make periodic payments of principal and interest. Title to the real property remains in the vendor until such time as the terms of agreement have been satisfied. At that time legal title is conveyed to the vendee by a separate deed.

[4] Those non-Hawaii domiciliaries who purchased a lot "sight unseen" on the basis of a written brochure were offered the so-called "Aloha Bonus Plan" whereby the out-of-state purchaser, upon traveling to Hawaii and viewing his lot would receive a voucher which would entitle him to a four hundred dollar credit against the principal balance due under the agreement of sale. From April of 1970 through August of 1973 some 256 purchasers viewed their lots under the "Aloha Bonus Plan."

1969 through November 30, 1971 the trust received at the offices of Grayco in Pasadena, California, some $924,898.33 in interest income from the agreements of sale of the Hawaii land. Of this amount some $207,187.00, or approximately 22% of the total amount, was paid by Hawaii residents. The remainder, approximately 78% of the interest income, was paid to Grayco as trustee at its Pasadena, California headquarters by non-domiciliaries of the State of Hawaii. The State of Hawaii through its Department of Taxation filed a Notice of Assessment against Grayco as trustee under HAW. REV. STAT. Chapter 237 on March 10, 1973. The assessment imposed a general excise (gross income) tax under HAW. REV. STAT. §237-13 on all of the interest income from the agreements of sale without apportionment of such interest income based upon the commercial domicile of the lender[5] or the domicile of the borrowers. The

[5] In 1967, the State of Hawaii enacted the Uniform Division of Income for Tax Purposes Act as part of the Hawaii Income Tax Law, HAW. REV. STAT. §§235-21 through 39. HAW. REV. STAT. §235-27, which was in effect during the period in question, provided that for purposes of income taxation interest income is "allocable to this State if the taxpayer's commercial domicile is in this State." The treatment of interest income as being earned at the commercial domicile of the lender is consistent with the view taken in the Restatement, *Conflict of Laws 2d* §195 (1971) that the substantive law applicable to questions concerning the lending of money is the law of the place where the debt is to be repaid. This view also finds support in Cleveland, Painesville and Ashtabula R.R. Co. v. Pennsylvania, 82 U.S. (15 Wall.) 300 (1873), the so-called "State Tax on Foreign Held Bonds" case. On the basis of these authorities, Petitioners argued, unsuccessfully, in the trial court and the court below that Hawaii State law required that the lending activity be deemed to have taken place in California, the commercial domicile of the lender for the purpose of the Hawaii General Excise Tax.

taxpayers paid the assessment under protest and thereafter commenced the instant proceedings to, among other things, require the apportionment of tax liability based upon the Due Process and Commerce Clauses of the United States Constitution. The case in the Tax Appeal Court of the State of Hawaii was tried pursuant to a detailed stipulation of fact and legal memoranda filed by the parties.[6] In its Findings of Fact and Conclusions of Law the trial court rejected the claim by the taxpayers that they were engaged in interstate commerce and were entitled to apportionment of the tax or interest income. The trial court ruled that the taxpayers were not engaged in interstate lending activity and even if they were, the tax on the full amount of interest income would still be due and owing to the State of Hawaii since the interest income was derived from agreements of sale pertaining to land located in the State of Hawaii. On appeal the Court below found against the taxpayers' contention that apportionment was required under the Due Process and Commerce Clauses of the Constitution. Although the Hawaii Supreme Court found that Petitioners received almost one million dollars in interest income, it specifically found that Grayco and Hawaiian Ranchos were not engaged in lending activity. For this

[6] Although the Rules of the Tax Appeal Court of the State of Hawaii do not preclude evidentiary hearings on tax matters, it is customary for the parties to enter into a detailed stipulation of fact as was done in this case. The trial court found each stipulated fact as being true and the court below accepted that finding as correct.

proposition the court below relied upon *Clifford v. State*, 469 P.2d 549 (Wash., 1969) which rejected[7] a claim by a land developer-vendor that the interest income from his land sale contract should enjoy the same exemption from general excise taxation as the interest earned by banks and other third party lenders who finance real property sales transactions. Although the Washigton Court in *Clifford v. State* was addressing an equal protection argument directed at state regulation of economic activity,[8] the court below had "no hesitancy" in applying the Washington Court's reasoning in characterizing the Petitioners' activities for the purpose of determining a federal constitutional claim under the Commerce Clause. Once the court below determined that no lending activity was involved, it was able to conclude, perforce, that no interstate lending activity was involved. Although the court below apparently concluded that Petitioners earned approximately one million dollars in interest income by

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[7]The court below found persuasive the following analysis from the Washington court (App. 31a-32a).

> The particular business activity of the appellants which is taxed is that of permitting deferred payment for the real estate which it sells. . . . Making a loan and taking a land contract as security is not the same activity as selling a piece of land and accepting the payment in installments. In one activity, money is advanced. In the other, no money is advanced by the seller; rather he relinquishes the right to immediate payment. This is a sufficient distinction in fact to justify the difference in tax treatment. . . .

[8]Without addressing the question of whether the Washington court in Clifford v. State applied the correct standard of review to an equal protection argument directed at state regulation of economic activity, it is submitted that the equal protection test is inapplicable to a commerce clause case.

"relinquishing" the right to immediate payment of the principal sum of the land sales contracts, it did not make further inquiry into the interstate nature of the "relinquishment" activity. Rather, the court below treated the "relinquishment" activity which produced the interest income as being part of the Petitioners' land development and sales activity. The characterization of the activity which produced the interest income as a species of land development and sales activity, however, did not change the fact that a significant part of the overall activity took place outside of the State of Hawaii. Nevertheless, the court below made an express determination that all of the Petitioners' activities took place, or rather, were deemed to have taken place at the situs of the land, within the state of Hawaii. The path by which the Court below reached this astonishing conclusion started with the venerable choice-of-law principle that questions regarding the title, alienation and transfer of real property are to be decided by reference to the substantive law of the jurisdiction in which the real property is situated. The court below reasoned that if questions such as title, alienation and transfer of real property are to be determined in accordance with the substantive law of Hawaii, and if Petitioner's lending or "relinquishment" activities which produced interest income were properly characterized as real property activities, then the federal constitutional question of power to tax was properly resolved by concluding that Hawaii had the power to tax the interest income in question. On that basis Grayco was found to be liable for an unapportioned gross income tax on all of the interest income from the land sale contracts pertaining to Hawaii land.

THE FEDERAL QUESTIONS WERE ADVANCED AT THE FIRST OPPORTUNITY AND WERE TIMELY RAISED

The federal questions presented herein were raised at the earliest opportunity in the trial court on October 18, 1973 in Petitioners' Complaint for the refund of the tax on interest income paid under protest, wherein Petitioners made the factual allegation:

> "To date, more than 1,200 lots in the trust estate are under separate contract of sale to purchasers, all or nearly all of which were executed outside the State of Hawaii and between non-resident purchasers and plaintiff Grayco, as trustee. . . ."

This was the first opportunity which the Petitioners had to present factual allegations upon which their claims rested. Thereafter in the Opening Brief filed in the trial court, which was the first opportunity to present legal argument and authorities, Petitioners devoted some ten pages of their Opening Brief to the claim that apportionment of the tax was required due to the interstate nature of the lending transactions. Petitioners reasserted their claim of apportionment in the court below in their opening brief and in their reply brief.

REASONS FOR GRANTING THE WRIT

The threshhold issue in this case is the right of a State court, in reviewing a federal constitutional claim under the Commerce Clause, to fictionalize, either the nature and character of interstate activity or its situs in a manner which renders the taxpayer's constitutional

claim moot or meaningless.[9] The case of *Central Greyhound Lines v. Mealey*, 334 U.S. 653 (1948) clearly directs State courts to avoid resorting to legal fictions in reviewing claims of exemption from taxation under the Commerce Clause. *See also Norfolk & Western R. Co. v. Missouri Tax Comm'n.*, 390 U.S. 317 (1968) (State tax apportionment formula which grossly distorts income from interstate activity held violative of taxpayer's right under the Commerce Clause). Under neutral principles of adjudication, interest income comes from the activity of lending money. Indeed, the court below so held in a previous case involving interest

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[9] Arguably, this case concerns the doctrine that this Court may review and disregard lower court adjudications of constitutional fact, a doctrine which has recently found its greatest currency in the area of personal freedoms, but which nonetheless appears equally applicable to other constitutional claims. See *e.g.* Haynes v. Washington, 373 U.S. 503, 515-16 (1963) wherein this Court stated:

> . . . [W]e cannot avoid our responsibilities by permitting ourselves to be "completely bound by state court determination of any issue essential to decision of a claim of federal right, else federal law could be frustrated by distorted fact finding." [Citation omitted.]

Since the facts were established by way of stipulation, it cannot be said that there was any distortion *per se* in the process of finding the facts. The distortion was in the improper characterization of facts; in other words, the distortion occurred in the secondary process of drawing inferences from empirical facts to establish as an ultimate or conclusory fact that all of the activity which produced the interest income took place (or was deemed to take place) in the State of Hawaii.

income from agreements of sale.[10] In economic terms, interest income is a charge[11] or "rental" for a deferral of the right to receive immediate payment of a sum currently due. In a transaction which produces interest income, there is a lender-relinquishor who agrees to defer the immediate receipt of the total amount due in return for a service charge commonly called "interest" paid by the borrower-relinquishee in consideration of the deferral of the immediate payment of the total amount due. The court below seized upon the fact that Petitioners as vendors of the land were not third party lenders[12] to the land sales transaction. According to the court below, Petitioners were engaged, not in the activity of lending, but in the activity of "relinquishing the right to immediate payment" of the principal balance in return for a consideration called interest.

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[10] Hawaiian Beaches, Inc. v. Kondo, 52 Haw. 279, 281, 474 P.2d 538, 540 (1970). In *Hawaiian Beaches*, the court below held that interest income from agreements of sale comes from the lending of money and thus does not fall within the purview of HAW. REV. STAT. §237-3 which exempts from general excise taxation the "gross receipts . . . from the sale of land in fee simple." In the instant case the court below held that interest income from Agreements of Sale does not come from lending of money and is land related activity which cannot be the subject of interstate commerce.

[11] See Due, *Intermediate Economic Analysis* (1947) pp. 225-7.

[12] The record clearly does disclose, however, that Exeter Equities, a Massachusetts limited partnership having its principal place of business in Boston, Massachusetts and Dow Banking Corporation, a Swiss banking corporation having its principal place of business in Zurich, Switzerland, both advanced substantial amounts of money to the trust and became beneficiaries thereunder.

What the court below failed to recognize was that third party lenders also engage the same type of "relinquishment" of the right to immediate repayment in order to receive interest income. For the purpose of the Commerce Clause, this supposed distinction between "relinquishment" and lending is a classic case of a distinction without a difference. For the purpose of the Commerce Clause, it is essential to define and characterize commercial activity in economic terms as opposed to terms which are merely semantic. Accordingly, the conclusion of the court below that interest income received by Petitioners was derived from "relinquishment" of the immediate receipt of the total amount due, followed by a refusal by the court below to consider the interstate nature of such "relinquishment" activity violated Petitioners' right to a fair adjudication of their Commerce Clause claim. The Constitution requires that the tests of the Commerce Clause be fairly and evenly applied to the facts of the case, not to presumptions, fictions and characterizations superimposed upon the facts.

The issue properly before the court below was the power of the State of Hawaii to levy a totally unapportioned gross receipts tax on approximately one million dollars of interest income from 17 to 19 year land sale contracts.[13] The facts clearly showed that while the land which was the subject matter of each

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[13] Under HAW. REV. STAT. §237-3 the gross proceeds of the sale of land in fee simple are exempt from the Hawaii GeneralExcise Tax.

land sale contract was located in Hawaii, the commercial domicile[14] of the lender and place of receipt of the interest and principal payments was in California, and the domicile of approximately 78% of the persons paying the monthly principal and interest payments was outside the State of Hawaii. The court below went beyond merely characterizing the activity which produced the interest income as "relinquishment" by holding that the "relinquishment" activity was part of an integrated land development and sales[15] activity.

It is the grouping of interstate lending or "relinquishment" activity with localized land ownership, sales and development activity for the purpose of imposing an unapportioned gross income tax on interest income which violates the Petitioners' right to Due Process of Law. HAW. REV. STAT. §237-13, which imposes the gross income tax, provides as follows:

> There [are] hereby levied . . . privilege taxes against persons on account of their . . . activities in

[14]There was no finding by either the trial court or the court below that the establishment of the trust in 1969 and its location in the State of California was a sham or fraud on the State of Hawaii, nor could there have been such a finding. The facts clearly show that California law required an impound device such as a trust where undeveloped subdivided land was to be sold to California residents, as it was in this case.

[15]Clearly all of the ownership and the physical development had to take place in Hawaii. The activity, if you will, of owning land is subject to a separate real property tax under HAW. REV. STAT., Chapter 246. Sales activity, however, to which the lending (or relinquishment) has a much closer relationship, took place both inside and outside the State of Hawaii. If sales results can constitute some accurate measure of sales activity, then some 78% of the sales activity took place outside the State of Hawaii.

> the State measured by the application of rates against . . . gross income. . . .

Due Process requires strict adherence to that portion of the statute which levies the tax "on account of . . . activities in the State" in order that there be a sufficient nexus between the State of Hawaii and the activity subject to tax. The Due Process nexus must appear from the facts of the case, not from abstractions superimposed upon the facts. In other words, the fact that the taxpayer is clearly engaged in activity "A" within the borders of the State, does not provide a sufficient Due Process nexus to permit the State to tax the proceeds of the taxpayer's activity "B" which occurs outside of the State. Where the proper Due Process nexus is lacking, the mere abstract thought process of grouping or combining out-of-state activities with in state activities cannot supply the missing nexus. *See American Oil Co. v. Neill*, 380 U.S. 451, (1965)[16] which held that a state may not levy a gross income tax on income producing activity taking place outside of the state's borders merely because the taxpayer is also simultaneously engaging in other similar or related

[16]In that case the taxpayer, a fuel dealer licensed and presumably conducting a fuel business in the State of Idaho, entered into a contract outside the state to deliver fuel to a common carrier at a F.O.B. point outside the state for ultimate delivery by the carrier to a buyer in the State of Idaho. The State of Idaho imposed an excise tax of six cents per gallon on the theory that the taxpayer constructively "received" the fuel in Idaho and upon the basis that the taxpayer was a licensed dealer. The Supreme Court rejected the Idaho Court's presumption of constructive receipt on Due Process grounds, since all of the incidents of the transaction took place outside of the State.

activity clearly within borders of the state. By combining lending and land ownership activity the Court below has unconstitutionally sought to "[p]roject the taxing power of the state plainly beyond its borders." *Nashville, C. & St. L. Railway v. Browning*, 310 U.S. 362, 365, (1940). *Accord, Norfolk & Western R. Co. v. Missouri Tax Comm'n.*, 390 U.S. 317, 324-5 (1968). Similarly, the grouping of lending and land ownership constitutes an "unrealistic formula" for dealing with apportionment of taxation of interstate commerce which unreasonably burdens interstate commerce. *Norfolk & Western R. Co. v. Missouri Tax Comm'n.*, 390 U.S. 317 (1968).

The ultimate deficiency in the reasoning process of the court below is in its reliance upon choice-of-law principles to resolve a constitutional question. After grouping the lending (or relinquishment) activity with land ownership activity and characterizing the resultant combination as being essentially real property activity, the court below asked the rhetorical question of what rule of law should be applied to issues involving real property. Not surprisingly, the answer was the "universal principle that real property is exclusively subject to the law of the country or state in which it is situated." (App. 35a) *See e.g. Restatement, Conflict of Laws 2d* §223 (1971). Thus, in effect, the court below concluded that all of Petitioners' activity was deemed to have taken place inside the State of Hawaii because the land was situated there.[17] The defect in the

[17]The vice in the reasoning process of the court below may be summed up in Cardozo's statement in Berkey v. Third Avenue Ry. Co., 244 N.Y. 84, 155 N.E. 58 (1926):

> Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.

application of this conflict of laws approach to constitutional questions is clear. Choice-of-law rules merely tell a court which of two competing substantive rules of state law is to be applied in a particular case on a particular issue. Choice-of-law rules, being rules of state common law must yield, under the Supremacy Clause of the United States Constitution, to the requirements of the Due Process and Commerce Clause on the issue of taxation of interstate commerce. *See* Restatement, *Conflict of Laws 2d* §2 (1971), particularly comment (b).

Beyond the threshhold question of distortions and fictions in the fact finding process lie the important questions of whether lending activity between citizens of two or more states is interstate commerce entitled to protection from vicissitudes of unfettered taxation by state governments, and if so, the appropriate constitutional standards for apportionment. Cases which have articulated a general definition of interstate commerce clearly seem to indicate that interstate lending is a species of interstate commerce. *See Dahnke-Walker Milling Co. v. Bondurant*, 257 U.S. 282 (1921); *Fisher's Blend Station v. Tax Comm'n. of the State of Washington*, 297 U.S. 650 (1936). There is scant authority, however, for the narrow proposition itself. The case of *Cleveland, Painesville and Ashtabula R. R. Co. v. Pennsylvania*, 82 U.S. (15 Wall.) 300 (1873), the so-called "State Tax on Foreign Held Bonds" case contained the germ of a Due Process argument requiring that interest income be taxed only at the commercial domicile of the lender on the theory that the debt constituted "property" which was taxable only in the hands of the holder of the debt. The application of

such a rule of apportionment in the instant case would have resulted in no tax on interest income to the State of Hawaii. A vast body of Commerce Clause litigation before this Court since the "State Tax on Foreign Held Bonds" case, however, argues against a hard and fast rule of apportionment based upon the commercial domicile of the lender. Rather, the recent cases appear to favor a rule which permit each state having a connection with the interstate lending to exert its taxing powers:

> "in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred. . . ."

Wisconsin v. J. C. Penney Co., 311 U.S. 435, 444 (1940). *Accord, Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 465 (1959). At least one court has resolved the question by holding that taxes upon interest income from interstate lending should be apportioned based upon the domicile of the borrower. *See Petition of Union Electric Co.*, 349 Mo. 73, 161 S.W.2d 968 (1942).

Regardless of the apportionment formula to be applied, it is clear that had the court below applied the basic tests to the facts of the case at bar, it would have found the wholly unapportioned gross income tax a clear violation of both the Commerce Clause and the Due Process Clause. *Hans Rees' Sons, Inc. v. North Carolina Ex. Rel. Maxwell*, 283 U.S. 123 (1931); *J. D. Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938); *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939); *Central Greyhound Lines v. Mealey*, 334 U.S. 653 (1948). The reason that a totally unapportioned tax on gross income from interstate commerce cannot

pass muster under the Constitution is stated generally in *Gwin, White & Prince, Inc. v. Henneford, supra*, 305 U.S. 434 at 438:

> [An unapportioned tax on gross income] by the very method of its measurement reaches the entire interstate commerce service rendered both within and without the state and burdens the commerce in direct proportion to its volume.

CONCLUSION

While there has been significant growth in interstate lending activity in the more than one hundred years since the "State Tax on Foreign Held Bonds" case was decided, there has been virtually no case law from this Court on the precise point of treatment of interest income under the Due Process and Commerce Clauses of the United States Constitution. The dearth of explicit authority from this Court has allowed the court below to assert localized land ownership as a bar to constitutional protections to which interstate lenders would otherwise be entitled. The highest court of the State of Indiana has made a similar ruling. *See Gross Income Tax Div. v. Bartlett*, 228 Ind. 505, 93 N.E.2d 174 (1950), *appeal dismissed*, 340 U.S. 924 (1951). The interstate flow of funds to finance real property transactions is a matter of obvious national importance. The ruling by the court below, coupled with an earlier ruling by Indiana's highest court, has cast serious doubt upon the question of whether interstate lending is entitled to the same constitutional protections as other interstate business or, whether interstate lending activity loses its constitutional protection where such lending

activity has a connection with real property located in the taxing jurisdiction. Because the matter is of national importance to interstate lenders and state governments alike, this Court ought to hear and decide the constitutional issues presented by this case.

Respectfully submitted,

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May, 1977

APPENDIX

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§235-27 *Allocation of interest and dividends.* Interest and dividends are allocable to this State if the taxpayer's commercial domicile is in this State.

§237-3 *"Gross income", "gross proceeds of sale", defined.* "Gross income" means the gross receipts, cash or accrued, of the taxpayer received as compensation for personal services and the gross receipts of the taxpayer derived from trade, business, commerce, or sales and the value proceeding or accruing from the sale of tangible personal property, or service, or both, and all receipts, actual or accrued as hereinafter provided, by reason of the investment of the capital of the business engaged in, including interest, discount, rentals, royalties, fees, or other emoluments however designated

and without any deductions on account of the cost of property sold, the cost of materials used, labor cost, taxes, royalties, interest, or discount paid or any other expenses whatsoever. . . .

"Gross proceeds of sale" means the value actually proceeding from the sale of tangible personal property without any deduction on account of the cost of property sold or expenses of any kind.

The words "gross income" and "gross proceeds of sales" shall not be construed to include: gross receipts . . . . except as otherwise provided, from the sale of land in fee simple, improved or unimproved, ...

§237-13 *Imposition of tax.* There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales or gross income, whichever is specified, as follows:

. . .

(10) Tax on other business. Upon every person engaging or continuing within the State in any business, trade, activity, occupation, or calling not included in the preceding paragraphs or any other provisions of this chapter, there is likewise hereby levied and shall be assessed and collected, a tax equal to four per cent of the gross income thereof. In addition, the rate prescribed by this paragraph shall apply to a business taxable under one or more of the preceding paragraph or other provisions of this chapter, as to any gross income thereof not taxed thereunder as gross

income or gross proceeds of sales or by taxing an equivalent value of products, unless specifically exempted.

§237-21 *Apportionment.* If any person, other than persons liable to the tax on manufacturers as provided by section 237-13(1), is engaged in business both within and without the State or in selling goods for delivery outside the State, and if under the Constitution or laws of the United States the entire gross income of such person cannot be included in the measure of this tax, there shall be apportioned to the State and included in the measure of the tax that portion of the gross income which is derived from activities within the State, to the extent that the apportionment is required by the Constitution or laws of the United States. In the case of a tax upon the production of property in the State the apportionment shall be determined as in the case of the tax on manufacturers. In other cases, if and to the extent that the apportionment cannot be accurately made by separate accounting methods, there shall be apportioned to the State and included in the measure of this tax that proportion of the total gross income, so requiring apportionment, which the cost of doing business within the State, applicable to the gross income, bears to the cost of doing business both within and without the State, applicable to the gross income.

IN THE TAX APPEAL COURT OF
THE STATE OF HAWAII

GRAYCO LAND ESCROW, LTD., and HAWAIIAN RANCHOS, INC. dba KBSF LAND CO., INC.,	)	T.A. No. 1460
Plaintiffs,	)	FINDINGS OF FACT AND CONCLUSIONS OF LAW
vs.	)	
RALPH W. KONDO, Director of Taxation, State of Hawaii,	)	
Defendant.	)	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This case came on for decision on a Stipulation of Facts and Second Stipulation of Facts and the Court, having duly considered the briefs and oral arguments of counsel and otherwise being fully advised in the premises, makes the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

This proceeding is an appeal brought by plaintiffs, Grayco Land Escrow, Ltd. (Grayco), and Hawaiian Ranchos, Inc., dba KBSF Land Co., Inc. (KBSF), pursuant to the provisions of HRS §40-35, for the recovery of general excise taxes they paid under protest

which were assessed against interest income Grayco derived from installment contracts of the sale of land located in Hawaii.

The facts in this case are set forth in the Stipulation of Facts and Second Stipulation of Facts on file with the record of this appeal and the Court accordingly finds the facts as stipulated by the parties.

CONCLUSIONS OF LAW

1. HRS §237-13(10) imposes a privilege tax against persons on account of their business and other activities in the State measured by gross income not covered by the preceding subsections.

HRS §237-1 defines a person to include every corporation, trustee or trust estate whether such persons are doing business for themselves or in a fiduciary capacity and whether they are residents or nonresidents of the State.

HRS §237-3 defines "gross income" to mean all receipts by reason of the investment of capital of the business engaged in, including interest.

2. Grayco contends that it was not doing business in the State and hence is not liable for the tax assessed herein. The Court disagrees. The Court finds that Grayco is engaged in the business of investing capital in the State of Hawaii within the meaning of the Supreme Court's holding in *Hawaiian Beaches v. Kondo*, 52 Haw. 279 (1970). The fact that Grayco is not a domiciliary of the State does not alter the validity of the tax as contended by plaintiffs. The tax is on the privilege of engaging in business activity in the State regardless of domicile. Accordingly, the Court concludes that the assessment is valid and proper.

3. Grayco contends that even if it is deemed to be doing business in the State of Hawaii, it is engaged in interstate commerce and is entitled to have its interest income apportioned under the Commerce Clause of the Federal Constitution. The Court disagrees. The Court finds that Grayco was not engaged in interstate commerce. Even if this Court were to find that Grayco was engaged in interstate commerce, that finding would not alter the validity of the assessment herein inasmuch as the interest income was derived from agreements of sale of land located in Hawaii.

4. The plaintiffs also contend that the assessment was improperly assessed against Grayco in its capacity as trustee in that it is merely the holder of bare legal title to the land in question for the real party in interest KBSF. The Court disagrees. Section 237-1 makes no differentiation between a trustee who holds bare legal title and one that does not. The section plainly and unambiguously provides for the tax liability of a trustee holding property for another whether he is in business for himself or in a fiduciary capacity. As such the Court concludes that the assessment against Grayco is proper.

5. The burden of showing that the failure to file a return is due to reasonable cause and not neglect is that of the taxpayer. In order for the Court to uphold the penalty, the Court need not find neglect. The absence of reasonable cause is sufficient. Mertens, *Law of Federal Income Taxation,* §55.23 (1970). To sustain the burden Grayco must show, in addition to its honest belief that it was not liable, other supporting factors, such as the advice of competent accountant or counsel. *Handley Motor Co. v. United States,* 338 F.2d 361 (1964). This, however, plaintiffs failed to do. The

record is bare of any factor supporting Grayco's belief. In the absence of such showing, the Court concludes that penalty imposed herein is proper.

6. The Director of Taxation in his Reply Brief concedes plaintiffs' contention that a portion of the assessment was based on an erroneous inclusion of $57,201.67. Based on the concession, the Court rules that all taxes, interest and penalties based thereon to be invalid.

7. Based on the above, the Court orders that judgment be entered as follows:

a. The sum of $53,085.99 paid under protest herein shall be and is hereby made a government realization.

b. The sum of $3,212.84 representing taxes, penalty and interest conceded by the Director of Taxation to have been erroneously assessed against interest income of Grayco unrelated to the case at hand, in the amount of $57,201.67, shall be refunded to Grayco together with interest at the rate of two per cent per annum as provided in HRS §40-35, and cost as provided in HRS §232-23.

Dated: Honolulu, Hawaii, Oct. 24, 1974.

Yasutaka Fukushima

[seal] Judge of the above-entitled Court

IN THE TAX APPEAL COURT OF THE STATE OF HAWAII

GRAYCO LAND ESCROW, LTD., et al.,	)	TAX APPEAL NO. 1460
Plaintiffs,	)	STIPULATION
vs.	)	OF FACTS
RALPH W. KONDO, Director of Taxation, State of Hawaii,	)	
Defendant.	)	

STIPULATION OF FACTS

For the purpose of the above-entitled proceedings only and without prejudice to the right to enter into additional stipulations of fact and to present other evidence to the Court, it is hereby stipulated by and between the parties hereto, through their respective counsel as follows:

1. During all times relevant herein, Grayco Land Escrow, Ltd., hereinafter referred to as "Grayco", was a corporation duly organized and existing under the laws of the State of California with its principal place of business located at Pasadena, California. During all times relevant herein, all of Grayco's officers and directors were California residents. By merger on January 15, 1974, Grayco became Wells Fargo Realty Services, Inc.

2. Grayco is licensed to do business in the State of Hawaii under the provisions of HRS Chapter 418 (foreign corporations), having first been licensed to

conduct business on March 27, 1969. Grayco is not licensed pursuant to the provisions of HRS Chapter 237. At no time has Grayco had a place of business or employees in the State of Hawaii.

3. Grayco holds title as trustee to a parcel of land subdivided into 3-acre parcels in accordance with law, located in the Kau District in the County and State of Hawaii, having received title by deed from KBSF Land Co. dated June 27, 1969 and recorded in Liber 6604, Page 242, Hawaii Bureau of Conveyances. At the time Grayco became trustee, the parcel contained 4002.2916 acres; the size of the parcel held by Grayco at any one time was dependent on the number of lots transferred by deed (see paragraph 6 herein). Tax Map Keys for the parcel are 9-2-152 through 155.

4. The trust agreement under which Grayco holds title to the land is known as "Subdivision Agreement No. 152" dated June 24, 1969 between Commonwealth United Corporation, of 8920 Wilshire Boulevard, Beverly Hills, California, KBSF Land Co., Inc., of 9756 Wilshire Boulevard, Beverly Hills, California, and Grayco Land Escrow, Ltd., of 739 East Walnut Street, Pasadena, California. The trust agreement was amended by instrument dated June 24, 1969 to add R.J. Beaumont & Associates, a California corporation, as a senior beneficiary of the trust, and amended and restated by instrument dated December 23, 1970, a true copy of which instrument is attached hereto as Exhibit 1. The relevant facts with respect to the administration of the trust by Grayco include the following:

(a) Grayco receives a fee for the trust services it performs. Outside the trust agreement, it has no relationship to the beneficiaries of the trust. The

establishment of the subdivision trust is required by sections 2814 et seq. of the California Administrative Code in order to sell lots in the State of California, such sections are attached as Exhibit 2.

(b) After a parcel of land is sold to a purchaser, and the sales contract executed by all parties, Grayco holds the sales contracts as part of the corpus of the trust estate until payment is made pursuant to its terms. None of the sales contracts are recorded in the Bureau of Conveyances of Hawaii or in any other State's record office. A typical contract is attached as Exhibit 3.

(c) All payments under the sales contracts are received by Grayco in California and are deposited in California banks until distribution is made to the beneficiaries of the trust in accordance with the trust agreement. Distributions are made weekly.

(d) When a purchaser has made all required payments under a contract of sale and otherwise performed his obligations thereunder, Grayco advises the purchaser by mail that the contract has been fully performed, that it will issue a deed in the purchaser's name, inquires whether the purchaser desires title insurance, advises the purchaser of the cost of insurance and recording, and requests the purchaser's directions and check in the necessary amount. If title insurance is requested, Grayco sends the deed to Title Guaranty of Hawaii with the purchaser's check and requests recordation of the deed and issuance of title insurance to the purchaser. If no insurance is required, Grayco mails the deed directly to the Bureau of Conveyances for recording. The deed is thereafter mailed to the purchaser. Each unrecorded contract of sale provided for a $1,000.00 minimum cash down payment and the balance of the sales price to be paid in monthly

installments of not less than $100.00 at 7% interest per annum for a term of 17 to 19 years.

(e) When a contract purchaser is in default, Grayco notifies KBSF Land Co. and the contract purchaser. If no cure is made, KBSF directs Grayco to cancel the contract pursuant to its terms. KBSF then adds the parcel to its inventory of lots to be sold.

(f) Grayco does not act independently, but receives all authority and directions from KBSF unless such acts are expressly set forth in, or prohibited by the trust agreement.

(g) The beneficiaries under the trust agreement are:

(i) Dow Banking Corporation, a Swiss banking corporation, with its principal place of business in Zurich, was the First Beneficiary. The interest of Dow Banking Corporation arose from the advance of funds to complete subdivision improvements on the land. Dow Banking Corporation was paid in full on July 29, 1973 and no longer has any interest under the trust agreement. Funds paid to Dow were provided by Exeter Equities and KBSF through a loan made on July 29, 1973 with First National Bank of Boston, secured by the interests Exeter Equities and KBSF have in the trust.

(ii) Exeter Equities, a Massachusetts limited partnership, whose principal place of business and post office address is 52 Church Street, Boston, Massachusetts, is the Second Beneficiary. Exeter Equities' interest arises out of the advance of funds by which KBSF purchased the land initially and paid for initial subdivision improvements. Exeter Equities succeeded to the interests of Commonwealth United Corporation.

(iii) Hawaiian Ranchos, Inc., a Delaware corporation, having its principal place of business at 52 Church

Street, Boston, Massachusetts, and doing business in the State of Hawaii as KBSF LAND CO., hereinafter referred to as "KBSF", is the Third Beneficiary. The interest of KBSF arises as the owner of the parcel prior to transfer in trust to Grayco and is the principal Beneficiary under the trust agreement.

(iv) R.J. Beaumont & Associates, a California corporation, having its principal place of business in Beverly Hills, California, is a senior Beneficiary. The interest of R.J. Beaumont & Associates arises from its activity as real estate broker in the promotion and sale of the subdivided lots pursuant to the Listing Agreement dated October 15, 1969, a true copy of which is attached as Exhibit 4.

5. The trust is funded by payments made to Grayco by individual purchasers of lots. The trust corpus consists of contracts of sale of land, income therefrom, and unsold lots.

6. The parcel of land conveyed to Grayco was subdivided into 1,229 lots in three increments, shown on maps filed in the Bureau of Conveyances of Hawaii as File Plans 962, 1145 and 1125. Of 1,229 lots, 1,179 lots are subject to sales contracts. Of the lots subject to sales contracts, 314 were sold to Hawaii residents; the rest were sold to residents of the continental United States and to foreign nationals. Sales of lots were made as follows:

Year	*Total*	*Hawaii Purchasers*
1969	49	23
1970	480	73
1971	358	90
1972	316	110
1973	122	18

To date 23 of the purchasers have completed payment on their unrecorded agreements of sale and Grayco has issued 23 deeds to lots which were recorded in the Hawaii Bureau of Conveyances. There have been 122 cancellations of contracts to date.

7. (a) Gross interest receipts from payments from the purchasers of all lots under the unrecorded agreements of sale received by Grayco in California for the period December 1, 1969 to November 30, 1970 totaled $282,510.00; for the period December 1, 1970 to November 30, 1971, such gross receipts totaled $642,388.33. (The assessment prepared by the Hawaii Tax Department was made on the basis of receipts reported in KBSF's federal tax return. The portion of the return related to interest income included amounts unrelated to land sales contracts in the sum of $55,101.67).

(b) Gross interest receipts from the Hawaii domiciliary purchasers of 314 lots for the period December 1, 1969 to November 30, 1970 totaled approximately $77,919.00; for the period December 1, 1970 to November 30, 1971, such gross receipts from Hawaii domiciliary purchasers totaled approximately $129,268.00.

8. Prior to May 1969, the 4002.2916 acre parcel was unimproved land. Certain improvements were made during the period May 1969 through September 1972 to comply with the provisions of HRS Chapter 484 (subdivision of land) and the ordinances and regulations of the County of Hawaii. Expenses incurred by KBSF for the construction of the improvement totaled $2,551,762.99. The improvements included construction of roads and related improvements by Kuwaye Brothers, Inc., a Hawaii corporation, having its principal

place of business in Hilo, under contracts dated May 20, 1969, January 30, 1970 and April 24, 1970. Facilities for electrical utility service have been constructed by Hilo Electric Light Company, Limited, a Hawaii corporation, having its principal place of business in Hilo, Hawaii, pursuant to contracts dated October 27, 1969 and February 5, 1970. Funds for construction were advanced by KBSF. Hilo Electric is obligated to refund to KBSF all revenues earned by the lines for a period of 60 months after installation is complete. KBSF also provided bonds naming the County of Hawaii as principal obligee to secure the timely and complete performance of the County required improvements. The average face value of the bonds given by KBSF to the County of Hawaii for the period February 1969 to February 1972 was $729,257.00. KBSF also caused a viewing structure to be constructed on a lot in the subdivision at a cost of $20,000.00. This structure was located at a spot providing a nice view of the land and surrounding environs. It consisted of a deck with a roof and included toilet facilities. Prospective purchasers in Hawaii and purchasers on the Aloha Bonus Plan were brought to the pavilion by real estate salesmen as part of the tour of properties.

9. R.J. Beaumont & Associates ("Beaumont" herein) was employed as exclusive agent to market the property pursuant to the Listing Agreement dated October 15, 1969, attached as Exhibit 4. All advertising copy was prepared by Wenger & Michael, Inc., a California corporation, having its principal place of business in San Francisco, California, at the direction and expense of Beaumont. Sales and marketing activity for the period December 1, 1969 to November 30, 1971 included the following:

(a) *In the State of Hawaii.* Advertisements of the availability of subdivided lots for sale were made through the use of newspapers, radio and television facilities located in the State of Hawaii, and United States mail. Examples of newspaper copy, radio and television scripts, and letters are attached hereto as Exhibits 5, 6, 7, and 8, respectively. Beaumont engaged subagents within the State to contact prospects and to sell the lots. These subagents were licensed Hawaii real estate sales persons. Brochures were handed out to purchasers in Hawaii. An example is attached as Exhibit 9.

(b) *In the State of California.* Advertisements of the availability of subdivided lots for sale were made through use of newspaper, radio and television facilities located in the State of California and the United States mail.

(c) *Other activities.* Direct mail offerings were made by Beaumont to residents of states other than California and included material attached as Exhibit 9. Regardless of where and how a sale was made, each prospective purchaser was provided with a copy of disclosure required by the Federal Land Sale Disclosure Act. Purchasers in Hawaii received a copy of the Public Offering Statement filed with the Hawaii Department of Regulatory Agencies. Purchasers in California were provided with a copy of the Public Offering Statement filed with the California Department of Real Estate.

Purchasers were offered an "Aloha Bonus Plan." Within two years after the execution of a sales contract, a purchaser traveling to Hawaii could arrange to view the lot he purchased. During the period between April 1970 and August 1973, 256 purchasers viewed lots under this plan. The purchaser would meet a real estate

sales person, a subagent employed by Beaumont, in Kailua, Kona, Hawaii, who would drive him to his lot and return him to Kailua, Kona. The sales person would sign a receipt and give it to the purchaser. Upon the purchaser sending the receipt to Grayco, Grayco would credit the principal balance under the sales contract in the amount of $400.00. The sales contract was in no way contingent on the purchaser viewing his lot, nor was an option to cancel included in the Bonus Plan or sales contract.

10. On or about March 10, 1973, Grayco was assessed as general excise tax for the period December 1, 1969 to November 30, 1970, the sum of $11,300.00 and for the period December 1, 1970 to November 30, 1971, the sum of $27,983.00, together with a 25% penalty of $9,821.00, $7,186.33 as interest and $7.50 for general excise tax license fees as shown as set forth in Exhibit "A" to the Complaint herein; the assessment was computed as 4% of the gross interest income for all of the lots and other interest unrelated to lot sales; the amount of said assessment of $56,298.83 was paid under protest by Grayco on October 1, 1973, and the action herein was commenced on October 18, 1973.

DATED: Honolulu, Hawaii, May 10, 1974.

/s/ Gary L. Wixon
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/s/ Tany S. Hong
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Of Counsel:
CASE, STACK, KAY,
CLAUSE & LYNCH

[Exhibits Omitted]

IN THE TAX APPEAL COURT OF THE STATE OF HAWAII

GRAYCO LAND ESCROW, LTD., et al.,	)	TAX APPEAL NO. 1460
Plaintiffs,	)	SECOND
vs.	)	STIPULATION
	)	OF FACTS
RALPH W. KONDO, Director of Taxation, State of Hawaii,	)	
Defendant.	)	

SECOND STIPULATION OF FACTS

For the purpose of the above-entitled proceeding only and without prejudice to the right to enter into additional stipulations of fact and to present other evidence to the Court, the parties hereto, through their respective counsel hereby supplement and amend the Stipulation of Facts filed herein on May 10, 1974 by stipulating as follows:

. . .

4. All of the contracts for the sale of individual lots were executed on the form entitled "HAWAIIAN OCEAN VIEW RANCHOS, Standard Form, Agreement for Sale of Real Property", a copy of which form is attached to the Stipulation of Facts filed herein on May 1, 1974 as Exhibit 3. The procedure for execution of said form in the State of California and in Hawaii was for a licensed real estate sales person to fill in the name and address of the individual lot purchaser as "Buyer" together with the terms of the agreement and an acknowledgment of receipt of:

a) the State Commission's Public Report;
b) the Property Report issued pursuant to the rules and regulations of the Office of Interstate Land Sales Registration, United States Department of Housing and Urban Development; and
c) a Notice of Right to Recission required under the Federal Truth in Lending Act.

The individual lot purchaser in turn gave the sales person a down payment of not less than $100.00 in the form of a check payable to Grayco and signed the form in three places to acknowledge the terms set forth on the listed reports and notice of recission. The sales person then transmitted the form as signed by the individual lot purchaser, together with the down payment to R.J. Beaumont & Associates, Inc. at its Beverly Hills, California office; R.J. Beaumont in turn transmitted the form and down payment to Grayco at its Pasadena, California office where Grayco, by one of its officers, signed the form as Seller, deposited the initial down payment and sent a monthly payment book along with the completed sales form to the individual lot purchaser.

5. Paragraph 7(a) of the Stipulation of Facts filed herein on May 10, 1974 is amended to read as follows:

> 7. (a) Gross interest receipts from payments from the purchasers of all lots under the unrecorded agreements of sale received by Grayco in California for the period December 1, 1968 to November 30, 1970 totaled $282,510.00; for the period December 1, 1970 to November 30, 1971, such gross receipts totaled $642,388.33. (The assessment prepared by the Hawaii Tax Department was made on the basis of receipts reported to KBSF's federal tax return. The portion of the return related to interest income included amounts unrelated to land sales contracts in the sum of $57,201.67).

[amendment underscored.]

6. KBSF maintains a person to follow the progress of the construction of improvements, attend to the maintenance of the roads and viewing pavillion and oversee the property. This person is paid on a contractual basis, the manner of performance of his activities is not controlled by KBSF, it does not withhold employment taxes, social security payments, or provide benefits available to common law employees of KBSF. This person is paid from Boston by KBSF. A copy of a one year contract for the period July 8, 1970 to July 8, 1971, originally between Exeter Equities and one Clayn Pettingill, attached hereto as Exhibit "W", sets forth the duties between the two parties for that period.

DATED: Honolulu, Hawaii, July 11, 1974.

/s/ John P. Gillmor
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[Exhibits Omitted.]

IN THE TAX APPEAL COURT OF THE STATE OF HAWAII

GRAYCO LAND ESCROW, LTD., and HAWAIIAN RANCHOS, INC. dba KBSF LAND CO., INC., Plaintiffs, vs. RALPH W. KONDO, Director of Taxation, State of Hawaii, Defendant.	T.A. No. 1460 JUDGMENT

JUDGMENT

Pursuant to the Findings of Fact and Conclusions of Law filed on October 24, 1974, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that judgment be entered in favor of the Defendant herein as follows:

1. The sum of $53,085.99 paid under protest herein shall be and is hereby made a government realization.

2. The sum of $3,212.84 representing taxes, penalty and interest conceded by the Director of Taxation to have been erroneously assessed shall be refunded to Grayco together with interest at the rate of two per cent per annum as provided in HRS §40-35, and cost as provided in HRS §232-23.

Dated: Honolulu, Hawaii, Oct. 24, 1974.

Yasutaka Fukushima
[seal] Judge of the above-entitled Court

SUPREME COURT OF HAWAII—1

Syllabus

In the Matter of the Tax Appeal of GRAYCO LAND ESCROW, LTD. and HAWAIIAN RANCHOS, INC., dba KBSF LAND CO., INC., Taxpayers

NO. 5846

APPEAL FROM TAX APPEAL COURT
HONORABLE YASUTAKA FUKUSHIMA, JUDGE

JANUARY 14, 1977

RICHARDSON, C.J., KOBAYASHI, OGATA, MENOR AND KIDWELL, JJ.

STATUTES — *taxation — construction — HRS § 237-13(10).*

HRS § 237-13(10) evidences, in plain and unmistakable language, the intention of the legislature to tax every form of business, subject to the taxing jurisdiction, not specifically exempted from its provisions.

TAXATION — *general excise tax — exemption — interest.*

Interest received from agreements of sale of land in fee simple does not fall within the exemption of "gross receipts from the sale of land in fee simple." HRS § 237-3.

SAME — *interest for lending or selling — distinction.*

Making a loan and taking a land contract as security is not the same activity as selling a piece of land and accepting the payment in installments.

SAME — *same — foreign corporations — jurisdiction.*

A state's power to impose a privilege tax on a foreign corporation within its jurisdiction is well settled; and the fact that it is not a domicilliary of the taxing state is of little consequence.

SAME — *same — ad valorem tax — double taxation.*

The imposition of both an excise tax on a privilege or activity and an ad valorem tax on the value of property is not invalid as the taxes are imposed on separate incidents.

PROPERTY — *what law governs.*

It is a universal principle of law that real property is exclusively subject to the law of the country or state within which it is situated.

SAME — *same — taxation.*

All matters concerning taxation of such realty, title, alienation, and the transfer of such realty and the validity, effect, and construction which is to be accorded agreements intending to convey or otherwise deal with such realty are determined by the doctrine of lex loci rei sitae, that is, the law of the place where the land is located.

VENDOR AND PURCHASER — *same — executory contracts.*

Executory contracts for the sale of land, such as the agreements of sale involved herein, are governed by the law of the place where the real property is located.

CONSTITUTIONAL LAW — *taxation — apportionment — HRS § 237-21.*

HRS § 237-21 is only applicable when the entire gross income cannot be constitutionally included in the measure of Hawaii's general excise tax. It is clear that the taxable event in this case was the receipt of interest income derived from the sale of land located in Hawaii under agreements of sale and the taxable income here involved consists entirely of such receipts. Accordingly, apportionment is not necessary under the circumstances of this case.

STATUTES — *taxation — construction — HRS § 237-1.*

The construction or interpretation of a statute may be indulged in only in case of ambiguity or uncertain meaning. Where, as in this case, the language is plain and unmistakable, there is no room for construction; and, thus, it must be given its plain and obvious meaning. The court is bound by the plain, clear and unambiguous language of the statute.

TAXATION — *assessment — private agreement.*

The private agreement of the parties was not binding on the assessor and the latter was under no obligation to make a separate assessment by reason of such agreement.

SAME — *penalty and interest — reasonable cause — HRS § 231-39(b) (1).*

"Reasonable cause" has been interpreted to mean no more than the exercise of ordinary business care and prudence.

SAME — *same — same — same — burden of proof.*

The issue is one of fact and the burden of proving reasonable cause is on the taxpayer.

SAME — *same — same — same — same.*

To meet its burden of proof, the taxpayer must show the presence of other supporting circumstances, in addition to its honest belief, that it was not responsible for the tax.

OPINION OF THE COURT BY KOBAYASHI, J.

This appeal by Grayco Land Escrow, Ltd. (Grayco) and Hawaiian Ranchos, Inc., dba KBSF Land Co., Inc. (KBSF) is taken from an order denying motion to amend findings of fact and conclusions of law and from the final judgment of the Tax Appeal Court which determined that Grayco was liable for general excise taxes, penalty and interest assessed against interest income Grayco derived from installment contracts of the sale of land located in the County of Hawaii, State of Hawaii.

We affirm.

ISSUES

The issues on appeal are:

(1) Whether interest income received by a vendor, who is

a domiciliary of California, from the sales of subdivided property located on the Island of Hawaii under agreements of sale, executed out-of-state, is subject to the general excise tax of the State of Hawaii; and whether, if applicable, the general excise tax must be apportioned pursuant to the Constitution of the United States and the laws of the State of Hawaii.

(2) Whether Grayco, as trustee who holds legal title to the fee simple property and who executed the agreements of sale as vendor, is liable for the general excise tax.

(3) Whether Grayco established reasonable cause for its failure to file a general excise tax return within the purview of HRS § 231-39(b) (1).

STATEMENT OF THE CASE

The facts of the case were stipulated, and the stipulations of fact were incorporated into the findings of fact of the tax appeal court.

Grayco, a California corporation, having its principal place of business in Pasadena, California, has been registered as a foreign corporation authorized to do business in the State of Hawaii pursuant to HRS Chapter 418 (Foreign Corporations Generally) since March 27, 1969. Grayco is not licensed to do business pursuant to HRS Chapter 237 (General Excise Tax Law). At no time has Grayco had a place of business or any employees in Hawaii.

Prior to December 1971, KBSF, a Delaware corporation, had its principal place of business in Beverly Hills, California; thereafter, its principal offices were moved to Boston, Massachusetts. Although KBSF is licensed to do business in Hawaii, the record is unclear as to what HRS chapter KBSF is registered under.

By deed dated June 27, 1969, KBSF conveyed fee simple title of 4002.2916 acres of land[1] situated in the District of Kau, County and State of Hawaii, to Grayco, as trustee. The deed

[1] The parcel of land was subsequently subdivided into 1,229 lots of which 1,179 are subject to agreements of sale.

was recorded in Liber 6604, page 242, Hawaii Bureau of Conveyances. The unrecorded trust agreement, otherwise referred to as "Subdivision Agreement No. 152" and under which Grayco holds legal title to the above property, is dated June 24, 1969, and was twice amended and restated on October 15, 1969, and on December 23, 1970, respectively.

The Subdivision Agreement of June 24, 1969, was made between Grayco, KBSF and Commonwealth United Corporation (Commonwealth) and was for the benefit of Commonwealth as first beneficiary to secure indebtedness owed to it by KBSF in the amount of $5,400,000, which was used to purchase the land and paid for initial subdivision improvements. The $5,400,000 note, dated December 31, 1968, was secured by a mortgage on the Hawaii property in question.

The above Subdivision Agreement was amended and restated on October 15, 1969, to include R. J. Beaumont and Associates (Beaumont), a California corporation, having its principal place of business in Beverly Hills, California. As a senior beneficiary, Beaumont's interest arose from its activity as the exclusive real estate broker in the promotion and sale of the Hawaii property pursuant to a listing agreement dated October 15, 1969, through which Beaumont was to receive a percentage of every lot sold. Sales and marketing activities for the period December 1, 1969 to November 30, 1971,[2] included the following:

(a) *In the State of Hawaii.* Advertisements of the availability of subdivided lots for sale were made through the use of newspapers, radio, and television facilities located in Hawaii, and the United States mail. Beaumont engaged licensed Hawaii real estate sales persons to contact prospective purchasers and to sell lots.

(b) *In the State of California.* Advertisement of the availability of subdivided lots for sale were made through the use of newspapers, radio, and television facilities located in California, and the United States mail. Also, direct mail offerings

[2] The terms of the listing agreement were made irrevocable until December 31, 1971, unless terminated sooner pursuant to provisions in the listing agreement.

were made by Beaumont to residents of states other than California.

On March 11, 1970, Exeter Equities (Exeter), a Massachusetts limited partnership with its principal place of business in Boston, Massachusetts, succeeded to the interests of Commonwealth. On October 5, 1970, Exeter, by agreement with the shareholders of KBSF, purchased all of the issued and outstanding stock of KBSF in return for a release of the shareholders from their liability for the indebtedness secured by the Subdivision Agreement.

The Subdivision Agreement was again amended and restated on December 23, 1970, to include Dow Banking Corporation (Dow), a banking corporation established and maintained under the laws of Switzerland with its principal place of business in Zurich, Switzerland. As first beneficiary, Dow's interest arose from the advancement of funds to complete subdivision improvements on the land. Dow was paid in full on July 29, 1973, and no longer has any interest under the trust agreement. Exeter, having succeeded to the interests of Commonwealth, is the second beneficiary. Beaumont's interest as a senior beneficiary remained the same. KBSF, whose interest arose as the owner of the property prior to transfer in trust to Grayco, is the third and principal beneficiary under the trust agreement.

The trust arrangement is required under sections 2814, et. seq., of the California Administrative Code for the sale of subdivided land under an agreement of sale in the State of California. Section 2814.6(a) of the California Administrative Code requires that "record title to the property which is subject to the contract of sale" be transferred in trust "prior to or concurrently" with the execution and delivery of the contract of sale to the contract vendee. Under the circumstances of the case; it appears that title to the property was vested in Grayco prior to any sale of the property and prior to any substantial subdivision improvements.

Upon sale of a lot, Grayco, as vendor, and the conditional contract vendee execute a standard form agreement for sale of real property under which the purchaser paid the purchase

price in installments, including interest on the unpaid principal balance. Under the provisions of the trust, Grayco, as trustee, receives monthly principal and interest payments from the purchasers of the lots at its office in Pasadena, California. All payments under the sales contracts are deposited in a California bank and are ultimately distributed to the beneficiaries of the trust on a weekly basis. The trust corpus consists of these contracts of sale of land, income therefrom, and unsold lots.

Purchasers were offered an "Aloha Bonus Plan" which entitled the vendee to travel to Hawaii to view the property within a period of two (2) years from the date of the agreement of sale. Between April, 1970 and August, 1973, 256 purchasers viewed their lots under the plan. The purchaser would meet a real estate sales person, a subagent employed by Beaumont, in Kailua, Kona, Hawaii, who would drive him to his lot and return him to Kailua, Kona. The sales person would sign a receipt and give it to the purchaser.

Upon the purchaser sending the receipt to Grayco, Grayco would credit the purchaser's balance owing on the principal in the amount of $400.00.

When a purchaser has performed all of the terms of the agreement of sale, Grayco advises the purchaser by mail that the contract has been fully performed, that it will issue a deed in the purchaser's name, inquires whether the purchaser desires title insurance, advises the purchaser of the cost of insurance and recording, and requests the purchaser's directions and check in the necessary amount. If title insurance is requested, Grayco sends the deed to Title Guaranty of Hawaii with the purchaser's check and requests recordation of the deed and issuance of title insurance to the purchaser. If no insurance is required, Grayco mails the deed directly to the Bureau of Conveyances for recording. The deed is thereafter mailed to the purchaser. Each unrecorded agreement of sale provided for a $1,000.00 minimum cash down payment and the balance of the sales price to be paid in monthly installments of not less than $100.00 at 7% interest per annum for a term of 17 to 19 years. Grayco pays itself out

of such cash receipts the amount due it for its services and, in addition, pursuant to Article XV.1 of the trust agreement, for "all taxes, assessments, insurance costs, charges, attorney's fees, expenses incurred or expended with BENEFICIARIES consent in the care, management, administration, protection and/or distribution of all or any part of the TRUST ESTATE for the payment of which the TRUST ESTATE and/or [Grayco] may become chargeable, including the protection of this Trust and its defense against legal attack."

The Director of Taxation (Director), State of Hawaii, on March 10, 1973, mailed a Notice of Assessment of Additional General Excise Tax to Grayco assessing taxes, penalty and interest in the total amount of $56,298.83 on interest income derived from the sale of its property situated on the Island of Hawaii. On October 1, 1973, Grayco paid the taxes under protest and commenced the action herein on review on October 18, 1973. The Tax Appeal Court upheld the assessment by the Director in the amount of $53,085.99. Judgment in favor of Grayco was given in the amount of $3,212.84 which represented taxes, penalty and interest erroneously assessed.

OPINION

IS INTEREST INCOME RECEIVED BY A VENDOR, WHO IS A DOMICILIARY OF CALIFORNIA, FROM THE SALES OF SUBDIVIDED PROPERTY LOCATED ON THE ISLAND OF HAWAII UNDER AGREEMENTS OF SALE, EXECUTED OUT-OF-STATE, SUBJECT TO THE GENERAL EXCISE TAX OF THE STATE OF HAWAII; AND, IF APPLICABLE, MUST THE GENERAL EXCISE TAX BE APPORTIONED PURSUANT TO THE CONSTITUTION OF THE UNITED STATES AND THE LAWS OF THE STATE OF HAWAII?

Hawaii's general excise tax is imposed by Chapter 237, Hawaii Revised Statutes, and section 237-13 provides in part:

> There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income,

whichever is specified, as follows:

. . . .

The types of businesses and activities which are subject to the tax are then enumerated. HRS § 237-13(1)-(9).

Section 237-13(10) imposes a privilege tax on "other businesses" equal to four per cent of the gross income:

> (10) . . : [u]pon every person engaging or continuing within the State in any business, trade, activity, occupation, or calling *not included in the preceding paragraphs or any other provisions of this chapter* . . . In addition, the rate prescribed by this paragraph shall apply to a business taxable under one or more of the preceding paragraphs or other provisions of this chapter, as to any gross income thereof not taxed thereunder as gross income or gross proceeds of sales or by taxing an equivalent value of products, unless specifically exempted.

Thus, in plain and unmistakable language the statute evidences the intention of the legislature to tax every form of business, subject to the taxing jurisdiction, not specifically exempted from its provisions. *See Brodhead v. Borthwick*, 37 Haw. 314 (1946); *reh. denied* 37 Haw. 351 (1946); *aff'd* 174 F.2d 21, *cert. denied*, 338 U.S. 847 (1949).

Thus, the initial and primary issue is whether Grayco, as trustee, legal title holder to and vendor of the subdivided property on the Island of Hawaii, was ". . . engaging or continuing within the State in any business, trade, [or] activity . . ." within the meaning of HRS § 237-13(10).

HRS § 237-2 specifies what constitutes "business for purposes of chapter 237.[3] That section provides:

> § 237-2 "*Business*", "*engaging*" *in business, defined.* "Business" as used in this chapter, includes all activities (personal, professional, or corporate), engaged in or

[3] Appellants' reference to HRS chapter 418 for the determination of what constitutes "doing business" within the State is inappropriate as "significantly more business activity is required for qualification purposes than for taxing jurisdiction." In re Tax Appeal of Heftel Broadcasting Honolulu, Inc., 57 Haw. 175, 180 n. 4, 554, P.2d 242, 246 n. 4 (1976); *Three Kinds of Doing Business*, 23 Corp. Journal 163, 164 (1961).

> caused to be engaged in with the object of gain or economic benefit either direct or indirect, but does not include casual sales.
>
> The term "engaging" as used in this chapter with reference to engaging or continuing in business also includes the exercise of corporate or franchise powers.

In its Findings of Fact and Conclusions of Law, the Tax Appeal Court stated:

. . . .

> 2. Grayco contends that it was not doing business in the State and hence is not liable for the tax assessed herein. The Court disagrees. The Court finds that Grayco is engaged in the business of investing capital in the State of Hawaii within the meaning of the Supreme Court's holding in *Hawaiian Beaches v. Kondo*, 52 Haw. 279 [474 P.2d 538] (1970). The fact that Grayco is not a domiciliary of the State does not alter the validity of the tax as contended by plaintiffs. The tax is on the privilege of engaging in business activity in the State regardless of domicile. Accordingly, the Court concludes that the assessment is valid and proper.

In *Hawaiian Beaches, supra*, the appellants, Hawaii corporations, were assessed general excise taxes on interest income derived from the sales of its lands situated on the Island of Hawaii. In interpreting the exemptions from gross income under HRS § 237-3,[4] this court held that " '[i]nterest' is mentioned as one of several items comprising 'all receipts'

[4] HRS § 237-3, in relevant part, states:

> §237-3 "*Gross income*", "*gross proceeds of sale*", *defined.* "Gross income" means the *gross receipts*, cash or accrued, of the taxpayer received as compensation for personal services and the gross receipts of the taxpayer derived from trade, business, commerce, or sales and the value proceeding or accruing from the sale of tangible personal property, or service, or both, and *all receipts*, actual or accrued as hereinafter provided, by reason of the investment of the capital of the business engaged in, *including interest*, discount, rentals, royalties, fees, or other emoluments however designated and without any deductions on account of the cost of property sold, the cost of materials used, labor cost, taxes, royalties, interest, or discount paid or any other expenses whatsoever. . . .
>
> "Gross proceeds of sale" means the value actually proceeding from the sale of tangible personal property without any deduction on account of the cost of

and not as an inclusion of 'gross receipts' " *Id.* at 282, 474 P.2d at 540. We further stated that "interest received on an agreement of sale of land in fee simple does not come within the 'gross receipts from the sale of land in fee simple.' " *Id.* at 282, 474 P.2d at 541.

Similar to the case at hand, the agreements of sale were made and executed out-of-state and the installment payments, including interest, were also made out-of-state. This court, however, held that that fact did not deny Hawaii "the right to tax interest received by a domiciliary 'by reason of the investment of the capital of the business' in Hawaii." *Id.* at 283, 474 P.2d at 541.

The appellants contend that *Hawaiian Beaches* separated the capital outlay for land development from lending credit on installment payment agreements. As stated in appellant's opening brief at pages 16-17:

> In order to reach its ruling on the exemption issue, the Hawaii Supreme Court divided the agreement of sale transaction into its component economic parts of a sale of an interest in land and an extension of credit to finance the sale. . . . Thus, the activity in *Hawaiian Beaches, supra*, which produced the gross receipts subject to taxation under HRS Chapter 237, was not the selling or the improvement of land, but the extension of credit which in fact and in law produced the interest proceeds. . . .

The appellants further contend that they are involved in an interstate lending activity and, thus, argue that "the relevant inquiry must be as to the situs of the lending activity" pursuant to the holding in *Hawaiian Beaches*.

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property sold or expenses of any kind.

The words "gross income" and "gross proceeds of sales" *shall not be construed to include: gross receipts* from the sale of bonds or other evidence of indebtedness or stocks or, except as otherwise provided, *from the sale of land in fee simple*, improved or unimproved, dividends as defined by chapter 235; cash discounts allowed and taken on sales; the proceeds of sale of goods, wares, or merchandise returned by customers when the sale price is refunded either in cash or by credit; or the sale price of any article accepted as part payment on any new article sold, if the full sale price of the new article is included in the "gross income" or "gross proceeds of sales". . . . (Emphasis added.)

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We do not agree with appellant's contentions nor their interpretation of *Hawaiian Beaches, supra*. *Hawaiian Beaches* simply separated the selling price of the lot (gross receipts) from interest earned under the agreements of sale. And we held that "by reason of the investment of the capital of the business" engaged in by the taxpayer, *i.e.*, the development and sale of land, the interest earned therefrom is taxable gross income. We did not hold "by reason of the investment of capital" to mean "lending credit" as a new transaction or component. In enacting HRS § 237-3, which defines gross income as "the gross receipts . . . derived from . . . sales . . . and all receipts . . . by reason of the investment of the capital of the business engaged in, *including interest* . . ." (emphasis added) the legislature specifically and explicitly mentions the inclusion of interest "as one of several items comprising 'all receipts' and not as an inclusion of 'gross receipts.' " *Hawaiian Beaches, Inc. v. Kondo, supra*, at 282 474 P.2d at 540. In *Hawaiian Beaches* we were dealing with an exemption and held that interest from agreements of sale does not fall within the exemption of "gross receipts from the sale of land in fee simple."

The appellants' classification of their business transaction as a "lending activity" was similarly addressed by the court in *Clifford v. State*, 78 Wash. 2d 4, 469 P.2d 549 (1970). Aside from not finding any support in the language of the statute[5] for this proposition, the Washington Supreme Court stated:

> The particular business activity of the appellants which is taxed is that of permitting deferred payment for the real estate which it sells. * * * Making a loan and taking a land contract as security is not the same activity

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[5] Prior to the 1970 amendment, RCW 82.04.400 read, in pertinent part:

This chapter shall not apply to national banks, state banks, trust companies, *** mutual savings banks, building and loan and savings and loan associations with respect to their banking, trust, or savings and loan business *** but shall apply with respect to their engaging in any other business taxable hereunder, even though such other business is conducted primarily for the purpose of liquidating the assets thereof.

as selling a piece of land and accepting the payment in installments. In one activity, money is advanced. In the other, no money is advanced by the seller; rather he relinquishes the right to immediate payment. This is a sufficient distinction in fact to justify the difference in tax treatment. . . . [Id. at 8, 469 P.2d at 551].

We have no hesitancy whatsoever in declaring that the transaction involved herein is not a separate transaction constituting a lending activity.[6]

A state's power to impose a privilege tax on a foreign corporation within its jurisdiction is well settled; and the fact that it is not a domiciliary of the taxing state is of little consequence. *See Gross Income Tax Division v. Bartlett*, 228 Ind. 505, 93 N.E.2d 174 (1950), *appeal dismissed* 340 U.S. 924 (1951); 71 Am. Jur. 2d, *State and Local Taxation*, § 574, p. 838; *see also Tax Appeal of Heftel Broadcasting Honolulu, Inc.*, 57 Haw. 175, 554 P.2d 242 (1976). The tax involved is not discriminatory in that it treats all similarly situated "whether the individuals are residents or nonresidents of the State." HRS § 237-1(2). Furthermore, it should be noted that the assessment is based on the privilege or activity of doing business within the State and not on the fact of domicile.

However, a due process question, *i.e.*, whether extending HRS § 237-13(10) to Grayco violates due process because of a lack of "nexus" between the State and the transactions involved, must first be determined.

In *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940), Wisconsin's gross receipts tax for the privilege of carrying on a local business was imposed on a Delaware corporation with its principal place of business in New York. In upholding the tax, the United States Supreme Court stated at page 444:

> The Constitution is not a formulary. It does not demand of states strict observance of rigid categories nor

[6] The essence of appellants' argument is premised on the assertion that it is engaged in an interstate lending activity. Since we have concluded that no lending activity, either intrastate or interstate, was involved, appellants' reliance upon authority based on lending activities is inappropriate.

precision of technical phrasing in their exercise of the most basic power of government, that of taxation. For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. A *state is free to pursue its own fiscal policies, unembarassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society*.

. . . We cannot, however, be too often reminded that the limits on the otherwise autonomous powers of the states are those in the Constitution and not verbal weapons imported into it. "Taxable event," "jurisdiction to tax," "business situs," "extraterritoriality," are all compendious ways of implying the impotence of state power because state power has nothing on which to operate. These tags are not instruments of adjudication but statements of results in applying the sole constitutional test for a case like the present one. That test is whether property was taken without due process of law, or, if paraphrase we must, *whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return*. The substantial privilege of carrying on business in Wisconsin, which has here been given, clearly supports the tax, and *the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders*. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. [Citations omitted] (Emphasis added.)

It is conceded that "certain governmental benefits" were bestowed upon Grayco in Hawaii including "roads, police and fire protection". The appellants, however, contend that the imposition of the general excise tax on its ownership of the

property and the imposition of a real property tax amount to a double tax. This contention is without merit or basis. The tax in question is levied upon the privilege or activity of doing business within the state and not upon the property of the taxpayer. It is measured, not by the value of the property, and thus, creating an ad valorem tax, but by the income realized by the particular activity engaged in by the taxpayer within the state. As was aptly stated by the United States Supreme Court in *Ohio Tax Cases*, 232 U.S. 576 (1914) at pages 593-94:

> . . . [T]he exaction of four per cent of the gross intrastate earnings is not a property tax but an excise tax, whose amount is fixed and measured by such earnings; and double taxation in a legal sense does not exist unless the double tax is levied upon the same property within the same jurisdiction. Plaintiffs in error pay one tax with respect to property, another with respect to the privilege or occupation; hence the taxation is not double. [Citations omitted].

See also Clifford v. State, supra. Thus, it is clear that the imposition of both an excise tax on a privilege or activity and an ad valorem tax on the value of property is not invalid as the taxes are imposed on separate incidents. *See New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937).

We believe that, under the facts of this case, there was sufficient business activity by Grayco in this State to justify the privilege tax. Further, Grayco benefits not only from "road, police and fire protection" of the State, but also utilizes the State's recording offices, laws, courts and other opportunities, protection and benefits of the State. *Hawaiian Beaches v. Kondo, supra*.

Appellants argue, however, that if the general excise tax is found to be applicable "apportionment of the tax is required" because "the lending transaction[7] in question constituted commercial activity in interstate commerce in that there were lending transactions involving a California

[7] As noted earlier, appellants' argument is based on the false premise that it is engaged in a "lending activity". See discussion preceding footnote 6.

domiciled lender and borrowers domiciled in California, Hawaii and other state and foreign countries." Appellants contend that an unapportioned tax on the interest income would "include within its measure a substantial amount of income attributable to activity outside the State of Hawaii and would subject interstate commerce to the burden of multiple and cumulative taxation."

The Director contends that "apportionment is not needed because the income is derived from sources within the State." With this we agree.

It is a universal principle of law that real property is exclusively subject to the law of the country or state within which it is situated. *Sunderland v. United States*, 266 U.S. 226 (1924); *Assessor v. Commercial Pacific Cable Co.*, 16 Haw. 396 (1905); *Gross Income Tax Division v. Bartlett, supra;* 16 Am. Jur. 2d *Conflicts of Laws*, § 14. *See also Smith v. Smith*, 56 Haw. 295, 535 P.2d 1109 (1976). Therefore, all matters concerning taxation of such realty, title, alienation, and the transfer of such realty and the validity, effect, and construction which is to be accorded agreements intending to convey or otherwise deal with such realty are determined by the doctrine of lex loci rei sitae, that is, the law of the place where the land is located. *Munday v. Wisconsin Trust Co.*, 252 U.S. 499 (1920); *United States v. Crosby*, 11 U.S. (7 Cranch) 115, 116 (1812); *see County of Kauai v. Holt*, 17 Haw. 146 (1905); *see also Hilo Sugar Co. v. Minister of Finance*, 7 Haw. 665 (1889) and *Carter v. Hill*, 31 Haw. 264 (1930); 71 Am. Jur. 2d, *State and Local Taxation*, § 650; 16 Am. Jur. 2d, *Conflicts of Laws* § 15: Restatement 2d, *Conflicts of Laws*, § 222 (1971); 17 C.J.S. *Contracts*, § 17; 91 C.J.S. *Vendor and Purchaser* § 3. Executory contracts for the sale of land, such as the agreements of sale involved herein, are therefore governed by the law of the place where the real property is located. *Gross Income Tax Division v. Barlett, supra;* 16 Am. Jur. 2d, *Conflicts of Laws*, § 15.

The United States Supreme Court in *Curry v. McCanless*, 307 U.S. 357, 363-64 (1939), reiterated this doctrine stating:

> That rights in tangibles — land and chattels — are to

be regarded in many respects as localized at the place where the tangible itself is located for purposes of the jurisdiction of a court to make disposition of putative rights in them, *for purposes of conflict of laws, and for purposes of taxation*, is a doctrine generally accepted both in the common law and other legal systems before the adoption of the Fourteenth Amendment and since. *** The power of government and its agencies to possess and to exclude others from possessing tangibles, and thus to exclude them from enjoying rights in tangibles located within its territory, affords adequate basis for an exclusive taxing jurisdiction. When we speak of the jurisdiction to tax land or chattels as being exclusively in the state where they are physically located, we mean no more than that the benefit and protection of laws enabling the owner to enjoy the fruits of his ownership and the power to reach effectively the interests protected, for the purpose of subjecting them to payment of a tax, are so narrowly restricted to the state in whose territory the physical property is located as to set practical limits to taxation by others. . . .'' (Emphasis added.)

In upholding the legality of the tax,[8] the court, in *Gross Income Tax Division v. Bartlett, supra*, concluded that the sale of land located in Indiana constituted sufficient activity to justify tha tax upon the gross proceeds of the nonresident.

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[8] Indiana's gross income tax law is similar to our general excise tax except that the proceeds of the sale of land are included in the gross income of the taxpayer. This difference in fact is not determinative of the present issue under discussion.

Indiana's gross income tax provides in part by section 2:

(m) The term "gross income," except as hereinafter otherwise expressly provided, means the gross receipts of the taxpayer received *** from the sale of property, tangible or intangible, real or personal, or service, or any or all of the foregoing, and all receipts by reason of the investment of capital, including interest, discount, rentals, royalties, fees, commissions or other emoluments, however designated, and without any deductions on account of the costs of property sold, the cost of materials used, labor cost, interest or discount paid, or any other expense whatsoever, and without any deduction on account of losses; ***. [Citations omitted.].

The court found that the income was derived from sources in Indiana and, quoting from a previous case, stated:

> "We conclude that the tax in question [gross income tax] is an excise, levied upon those domiciled within the state or who derived income from sources within the state, upon the basis of the privilege of domicile or the privilege of transacting business within the state, and that the burden may reasonably be measured by the amount of income. The reasoning which justifies the tax upon the basis of domicile as readily supports and justifies a tax upon the basis of the right to receive income within, or transact business under the protection of, the state. We feel that the weight of reason and authority sustains this view." [Id. at 551, 93 N.E.2d at 177].

The court then proceeded to discuss two constitutional questions that invariably arise in any discussion of multi-state taxation — the due process and commerce clauses of the federal Constitution.

As to whether the assessment of the gross income tax on the principal and interest unconstitutionally infringed upon the due process clause of the federal Constitution, the Indiana Supreme Court held that the assessment did not. *Id.* at 512, 93 N.E.2d at 177. The court stated that "immovable property is exclusively subject to the laws of the government in which it is located." [Citations omitted.] *Id.* at 512, 93 N.E.2d at 177.

With respect to the commerce clause of the federal Constitution, the court stated in 228 Ind. at 511-12, 93 N.E.2d at 177:

> "It should also be remembered that contracts between citizens of different states are not subjects of interstate commerce where the performance of the contract is to be completed and carried out wholly within the borders of the state, even though such contracts may affect interstate commerce, [citations omitted] and *the appellee cannot escape the tax by billing from the outside or by setting up his machinery so that the income from the sale is paid*

to it from another state." [Citations omitted.]

. . . .

Only such commodities as may in the ordinary course of events become subjects of purchase and sale on their movement from one state to another state are articles of commerce under the Commerce Clause of the Constitution, art. 1, § 8, cl. 3, [citations omitted] and the decision of the lower court, which in this case holds real estate to be the subject of interstate commerce, is not sustained by the authorities. [Citations omitted.] (Emphasis added.)

The Hawaii apportionment statute is embodied in HRS § 237-21 which provides, in part:

§137-21 *Apportionment*. If any person . . . is engaged in business both within and without the State . . . and *if under the Constitution or laws of the United States the entire gross income of such person cannot be included in the measure of this tax*, there shall be apportioned to the State and included in the measure of the tax that portion of the gross income which is derived from activities within the State, to the extent that the apportionment is required by the Constitution or laws of the United States. In the case of a tax upon the production of property in the State the apportionment shall be determined as in the case of the tax on manufacturers. In other cases, if and to the extent that the apportionment cannot be accurately made by separate accounting methods, there shall be apportioned to the State and included in the measure of this tax that proportion of the total gross income, so requiring apportionment, which the cost of doing business within the State, applicable to the gross income, bears to the cost of doing business both within and without the State, applicable to the gross income. (Emphasis added.)

The above quoted apportionment statute is only applicable when the entire gross income cannot be constitutionally included in the measure of Hawaii's general excise tax. It is clear that the taxable event in this case was the receipt of interest income derived from the sale of land located in Hawaii under agreements of sale and the taxable income here

involved consists entirely of such receipts. Accordingly, apportionment is not necessary under the circumstances of this case. *See Hawaiian Beaches, Inc. v. Kondo, supra*.

IS GRAYCO, AS TRUSTEE WHO HOLDS LEGAL TITLE TO THE FEE SIMPLE PROPERTY AND WHO EXECUTES THE AGREEMENTS OF SALE AS VENDOR, LIABLE FOR THE GENERAL EXCISE TAX?

The Hawaii general excise tax is imposed upon "every person engaging or continuing within the State in any business, trade, [or] activity. . .". HRS § 237-13(10).

HRS § 237-1, *inter alia*, defines "person" to include:

. . . every individual, partnership, society, unincorporated association, joint adventure, group, hui, joint stock company, corporation, *trustee*, executor, administrator, *trust estate*, decedent's estate, *trust, or other entity, whether such persons are doing business for themselves or in a fiduciary capacity, and whether the individuals are residents or nonresidents of the State*, and whether the corporation or other association is created or organized under the laws of the State or of another jurisdiction. Any person who has in his possession, for sale in the State, the property of a nonresident owner, other than as an employee of such owner, shall be deemed the seller of the property, when sold. (Emphasis added.)

Grayco contends that it is not the proper taxpayer in that it is merely a "passive trustee" of a "flow through"[9] trust holding bare legal title to the property and has "no beneficial interest under the trust agreement in the land or trust corpus, except a lien for its fees and advances." Grayco argues that KBSF is the proper taxpayer under the category of "trust estate" or "other entity" pursuant to HRS § 237-1, *supra*. Grayco further contends that since KBSF is entitled to exclusive possession of the property so long as it is not in default to the other beneficiaries, and since, under the provisions of the

---

[9] Appellants' reliance upon the Internal Revenue Code is inappropriate. The Internal Revenue Code specifically excepts a "flow through" trust from the general rule that the income of a trust estate is taxable to the fiduciary. Mertens, *Law of Federal Income Taxation*, Vol. 6, §§ 36.18, 36.19 (1975). No comparable statutory exception is found in HRS Chapter 237.

trust agreement, KBSF has "the exclusive responsibility to subdivide, improve and sell the land . . . including the obligation to pay taxes", KBSF should be the proper taxpayer.

We find Grayco's contentions without merit. HRS § 237-1 clearly and unambiguously provides for the tax liability of a trustee holding property for another whether he is in business for himself or in a fiduciary capacity and whether he is a resident or nonresident of this State. The statute makes no differentiation between a trustee holding bare legal title and one that does not. The statute also makes no differentiation between a trustee of a passive or dry trust and an active trust. "The construction or interpretation of a statute may be indluged in only in case of ambiguity or uncertain meaning. Where, as in this case, the language is plain and unmistakable, there is no room for construction — there is nothing to construe," *Hawaiian Hotels v. Borthwick*, 35 Haw. 789, 794 (1941); and, thus, it must be given its "plain and obvious meaning." *Hawaii Consolidated Railway v. Borthwick*, 34 Haw. 269, 272 (1937). The Court is bound by the plain, clear and unambiguous language of the statute. *University of Hawaii v. Leahi Foundation*, 56 Haw. 404, 537 P.2d 1190 (1975).

Grayco's claims that it is merely a passive trustee who holds legal title is not convincing. Title to the property was vested in Grayco prior to any sale of the property and prior to any substantial subdivision improvements. Pursuant to the trust agreement, Grayco has substantial duties in respect to the collection of payments and cancellation of the agreements of sale. Payments under the agreements of sale, which are executed by Grayco as vendor, are made to Grayco. Grayco is under a duty to deposit all gross receipts in a separate bank account and not to co-mingle these funds with its own separate funds. If an account becomes delinquent, Grayco is under a duty to notify the purchaser of the property and beneficiaries under the trust. Furthermore, Grayco declares defaults and "of its own accord, may cancel any contract which is more than 90 days delinquent." Full and complete reports on the status of the trust estate must be given to the beneficiaries monthly. Upon payment in full of a sale of

property for cash, Grayco executes a grant deed to the purchaser entitled thereto or purchaser's nominee. Appellants cannot seriously contend that Grayco's duties are purely ministerial or passive.

The fact that KBSF is under a duty to pay all taxes assessed on the property pursuant to the trust agreement is also of no effect.[10] The trust agreement between the various parties is not binding on the taxing authority or determinative of the tax consequences. *See In re Taxes Kobayashi*, 44 Haw. 584, 358 P.2d 539 (1961); *Hilo Sugar Co. v. Tucker*, 8 Haw. 148 (1890). To hold otherwise would create havoc for the taxing authorities. "The private agreement of the parties was not binding on the assessor and the latter was under no obligation to make a separate assessment by reason of such agreement." *Oahu Railway and Land Co. v. Ewa Plantation Co.*, 15 Haw. 318, 323 (1903). Accordingly, we find Grayco, as trustee and legal owner[11] of the property in question, liable for the assessment of the general excise tax.

DID GRAYCO ESTABLISH REASONABLE CAUSE FOR ITS FAILURE TO FILE A GENERAL EXCISE TAX RETURN WITHIN THE PURVIEW OF HRS § 231-39(b) (1)?

In addition to the assessment of the general excise tax, Grayco was assessed a 25% penalty by the Director pursuant to HRS § 231-39(b) (1), which provides:

> (b) There shall be added to and become a part of the tax imposed by such tax or revenue law, and collected as such:
>
> (1) Failure to file tax return. In case of failure to file any tax return required to be filed on the date prescribed therefor (determined with regard to any

---

[10] Under the trust agreement, Grayco may reimburse itself for "all taxes, assessments . . . for the payment of which the trust estate and/or trustee may become chargeable, including the protection of [the] trust and its defense against legal attack."

[11] The definition of "legal owner" is stated in *Black's Law Dictionary*, 4th Ed. (1968) at page 1260:

> Legal owner. One who is recognized and held responsible by the law as the owner of property. In a more particular sense, one in whom the legal title to real estate is vested, but who holds it in trust for the benefit of another, the latter being called "equitable" owner.

> extension of time for filing), *unless it is shown that the failure is due to reasonable cause and not due to neglect*, there shall be added to the amount required to be shown as tax on the return five per cent of the amount of the tax if the failure is for not more than one month, with an additional five per cent for each additional month or fraction thereof during which the failure continues, not exceeding twenty-five per cent in the aggregate. . . . (Emphasis added.)

Thus, it is clear that the penalty is to be imposed unless the failure to file a tax return is "due to reasonable cause and not due to neglect." Section 6651(a) of the Internal Revenue Code is quite similar to HRS § 231-39(b)(1) in that it provides for an addition to the tax for failure to file a return on the prescribed date unless it is shown that such failure is due to reasonable cause and not neglect.

"Reasonable cause" has been interpreted to mean no more than the exercise of ordinary business care and prudence. *In re Fisk's Estate v. Commissioner of Internal Revenue*, 203 F.2d 358 (6th Cir. 1953); *Hayward Lumber & Mining Co. v. Commissioner of Internal Revenue*, 178 F.2d 769 (2d Cir. 1950). However, a mere showing of absence of willful neglect is insufficient to avoid the penalty. *West Virginia Steel Corporation v. Commissioner*, 34 T.C. 851 (1960). The issue is one of fact and the burden of proving reasonable cause is on the taxpayer. *Breland v. United States*, 323 F.2d 492 (5th Cir. 1963); *Lee v. Commissioner of Internal Revenue*, 227 F.2d 181, (5th Cir. 1955); *William J. Lemp Brewing Co. v. Commissioner*, 18 T.C. 586 (1952); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); Mertens, *Law of Federal Income Taxation*, Vol. 10, § 55.23 (1976).

Grayco maintains that its failure to file the tax return was "due to reasonable cause and not due to neglect" for two reasons.

Grayco contends, as its first basis for justifying the failure to file a return, that it "reasonably believed" that it was not responsible for the tax since it was a "flow through" trust. Grayco further contends that, on the basis of correspondence

with the Director, it had satisfied the requirements of Hawaii law. Correspondence between Grayco and the Director occurred between January 15, 1970 through March 9, 1970 and January 14, 1973 through January 23, 1973. In response to the Director's inquiries about activities concerning sales of Hawaii land and Grayco's responsibility for the general excise tax, Grayco continuously maintained that it was a "flow through" trust and that KBSF was the proper taxpayer.

Grayco's second basis was in its belief that tax liability was uncertain. Grayco relies on *Fairfax Mutual Wood Products Co. v. Commissioner*, 5 T.C. 1279 (1945). An examination of the Tax Court's opinion shows that in contrast to the instant case, there were, in addition to the taxpayer's belief, other circumstances sufficient to prove reasonable cause. *Fairfax* involved a taxpayer who contended that it was a personal service corporation pursuant to Internal Revenue Code § 725(a) and thus, was entitled to be exempt from excess profits tax. A question was also presented as to whether the taxpayer was subject to a 25% penalty for its failure to file an excess profits return. The court held that the taxpayer was not a personal service corporation and further determined that, under the circumstances of the case, the taxpayer's failure to file an excess profits tax return was due to reasonable cause and not to willful neglect. The taxpayer had "discussed fully the matter of making returns with the local collector and his subordinates and was told to file the income tax return and attach thereto a statement explaining the operation of the business and the basis for the corporation's claim." *Id.* at 1283. The taxpayer, following the tax collector's advice attached a detailed statement regarding the operation of its business and an explanation of the absence of the excess profits tax return to its return. We infer that the Tax Court relied upon these additional circumstances in holding that the failure to file the return was due to reasonable cause.

To meet its burden of proof, appellants must show the presence of other supporting circumstances, in addition to its honest belief, that it was not responsible for the tax. This was

aptly stated by the court in *Handley Motor Co. v. United States*, 338 F.2d 361, 366 (1964):

> It is generally recognized that the presence of certain factors, in addition to the honest belief of the taxpayer, constitutes reasonable cause for the failure to file a return, *e.g.*, the advice of a competent accountant or attorney; *Mayflower Investment Co. v. Commissioner*, 239 F.2d 624 (5th Cir. 1956); *Hatfried, Inc. v. Commissioner*, 162 F.2d 628 (3d Cir. 1947); or reliance on the statements of an Internal Revenue agent, *Druggists' Supply Corp.*, 8 T.C. 1343 (1947).

Absent reliance on competent counsel or the Director or his representative, Grayco's erroneous belief that it had no taxable income that would necessitate the filing of a return, was not reasonable cause. *Eleanor C. Shomaker v. Commissioner*, 38 T.C. 192 (1962); *Beck Chemical Equipment Corporation v. Commissioner*, 27 T.C. 840 (1957).

We conclude that the evidence offered by the appellants is insufficient to meet its burden of proving reasonable cause.

John P. Gillmor (Gary L. Wixom with him on the briefs; *Case, Stack, Kay, Clause & Lynch* of counsel) for Taxpayers, appellants.

Alana W. Lau, Deputy Attorney General, for Director of Taxation, appellee.

NO. 5846

IN THE SUPREME COURT OF THE STATE OF HAWAII

OCTOBER TERM – 1974

In the Matter of the Tax Appeal of GRAYCO LAND ESCROW, LTD., and HAWAIIAN RANCHOS, INC., dba KBSF LAND CO., INC., Taxpayers.	)	CASE NO. 1460

PETITION FOR REHEARING

TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF HAWAII:

Pursuant to Rule 5 of the Rules of the Supreme Court, Taxpayers-Appellants, Grayco Land Escrow, Ltd. and Hawaiian Ranchos, Inc., present this Petition for Rehearing of the above cause and in support thereof respectfully represent:

1. That on January 14, 1977 this Court rendered its opinion and judgment in the matter herein.

2. That said opinion holds that the activity of the taxpayer-appellants, in developing and selling parcels of subdivided real property in fee simple under 17 to 19 year Agreements of Sale produced, among other things, a type of income fairly described as interest income;

this Court has generally characterized the taxpayer's overall activity herein as being a land selling and development activity; it is clear that this Court has ruled that the activity which produced interest income was neither a lending activity nor is it permissible to treat the taxpayer's overall sales and development activity as having lending activity as one of its component parts.

3. That in a prior opinion in the case of *Hawaiian Beaches, Inc. v. Kondo,* 52 Haw 279, 474 P.2d 538 (1969), also dealing with the sale of subdivided land in fee simple under long term Agreements of Sale, this Court held that "interest arises not from the sale of any commodity, but rather as a charge for the use of money loaned". Based upon this view of the nature of interest income, this Court held in *Hawaiian Beaches, Inc. v. Kondo, supra,* that interest income from such Agreements of Sale did not constitute part of the "gross proceeds of the sale of land in fee simple" so as to be exempt from general excise taxation under HRS §237-3.

4. Implicit in the holding of *Hawaiian Beaches, Inc. v. Konda, supra,* is the concept that a transaction, such as the sale of subdivided land and the extension of credit to finance the purchase of such land, can and should be divided into component parts for the purposes of general excise taxation. Indeed, the separation of interest income and income from the land sale itself was essential to the Court's ruling that the land sale income, but not the interest income, was exempt from excise taxation under HRS §237-3.

5. In the opinion in the cause herein, this Court has cited with approval the holding of *Hawaiian Beaches, Inc. v. Kondo, supra,* that interest income is not

exempt from general excise taxation as part of the gross proceeds of the sale of land in fee simple; at the same time this Court has disavowed the very rationale upon which the holding of *Hawaiian Beaches, Inc. v. Kondo, supra,* was based, namely, that interest income comes only from the lending of money and that integrated activities such as a combined land selling and lending transaction, should be divided into their component parts for the purpose of the fair imposition of general excise taxes.

6. The apparent separation of the holding and the rationale of *Hawaiian Beaches, Inc. v. Kondo, supra,* creates a situation where taxpayers, tax practitioners and administrators within the tax system will experience great confusion in understanding and in applying the applicable law.

7. The taxpayer-appellants respectfully request a rehearing of the cause herein to clarify and harmonize the apparent conflict in the opinions in *Hawaiian Beaches, Inc. v. Kondo, supra,* and the cause herein, to define interest income in terms of the activity which produces such income, to define, under what circumstances, if any, it is appropriate to divide economic activity into component parts for the purpose of the Hawaii general excise tax and to reconsider whether the interest income in the case at bar should be exempt from general excise taxation, either as part of the gross proceeds of the sale of land in fee simple or as constituting income derived from lending activity outside of the State of Hawaii.

DATED: Honolulu, Hawaii, January 24, 1977.

/s/ JOHN P. GILLMOR
JOHN P. GILLMOR

Attorney for Taxpayers,
Appellants

NO. 5846

IN THE SUPREME COURT OF
THE STATE OF HAWAII

OCTOBER TERM – 1974

In the Matter of the Tax Appeal	)	CASE NO. 1460
	)	
	)	MEMORANDUM OF
of	)	POINTS AND
	)	AUTHORITIES
GRAYCO LAND ESCROW, LTD., and HAWAIIAN RACHOS, INC., dba KBSF LAND CO., INC.,	)	TAX APPEAL COURT
	)	
	)	HON. YASUTAKA
Taxpayers.	)	FUKUSHIMA
	)	JUDGE

MEMORANDUM OF POINTS AND AUTHORITIES

The holding of *Hawaiian Beaches, Inc. v. Kondo*, 52 Haw. 279, 474 P.2d 538 (1970) is based upon two concepts which have long and respectable traditions in legal thought: First, the concept that interest income can only arise from the lending of money and second, the concept that fairness in the administration of taxes requires that encomic activities which may be considered to constitute a single integrated activity for certain purposes, must be divided into component parts for the purpose of taxation. The opinion in the cause herein adheres to the holding of *Hawaiian Beaches, Inc. v. Kondo*, yet impliedly disavows the rationale. This separation of the holding from the rationale of prior authority causes doubt and confusion and thus calls for a rehearing of the issues.

In *Hawaiian Beaches, Inc. v. Kondo, supra*, the tax payer asked:

> May I exempt the interest income from the sale of land in fee simple under agreement of sale as part of the "gross proceeds" of that sale per HRS §237-3.

The answer to that question from this court was that interest income arises only from the lending of money[1]

[1] Implicit in this Court's reasoning in *Hawaiian Beaches, supra*, is the idea that the analysis of problems of taxation under HRS Chapter 237 is not a matter of mere semantics but requires an economic analysis the various types of returns on the basic economic factors of production, land, capital, labor and management.

Due, *Intermediate Economic Analysis* (1947) defines the receipts from the economic factors of production:

> . . . various persons have gained title to the land by inheritance or purchase and consequently receive payments from those persons who wish to use the land. Such payments are known as "rent."
>
> . . . However, the owner of the capital good must have obtained money capital with which to buy the good; the price paid by the owner for the use of this money capital, known as "interest," constitutes an income to the recipient. . . .
>
> In a free society those desiring to render labor services sell these services directly to the producers. Accordingly, the prices paid, known as "wages" constitutes the source of income of the workers. . . .
>
> No contractual payments are made for the entrepreneurial services, since the latter are supplied by the owners of the business. The share of income received by the latter, known as profits, consists of the remainder of receipts of a business after all contractual costs . . . have been covered. (pp. 225-7)

To the same effect, see 18 Encyclopedia Britannica, *Price:*

> In the classical tripartite division of the factors of production, wages are the price of the services of labourers,

(continued)

and the statute, HRS §237-3, exempts only "gross proceeds from the sale of land" not incidental interest income from the interrelated lending activity. Thus for the purpose of the exemption statute, HRS §237-3, the sales activity and lending activity of the sale of fee simple land under agreement of sale were treated as separate transactions.[2]

In the instant case the taxpayer asked the question,

> If interest income and, therefore, the lending activity which produces such interest is being taxed, How can the State of Hawaii constitutionally tax roughly two thirds of the lending

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(footnote continued from proceeding page)

rent is the price paid for the use of land (or of other resources, or assets, having the essential nondepreciating characteristic of Ricardian land), and interest is the price paid for the services provided by loans. Profits, however, are not regarded as the price of any productive services, or factor, but as a residual after all the firms contractual payments have been met. (p. 489)

[2] The separation of the land sales and lending components of the transaction is similar to the separation of land and improvements components of the transaction in *In Re Taxes Kobayashi,* 44 Hawaii 584, 358 P.2d 539 (1961). In that case the taxpayer was a homebuilder who acquired a tract of land, subdivided the tract into house-lots, and sold the land and the dwellings to be constructed for a single price. The trial court agreed with the taxpayer's contention that the sales contract was a single indivisable contract for the sale of what was essentially and predominantly a fee simple interest in land, and thus exempt from the Hawaii General Excise Tax under the predecessor of HRS §237-3. The Supreme Court held that although the contract for the sale of land and dwelling was, for the purposes of private contract law, a single indivisible contract, the transaction was divisible for the purpose of taxation. Accordingly, the Hawaii Supreme Court held that the portion of the sales price pertaining to the sale of land in fee simple was exempt from the Hawaii General Excise Tax, while the portion of the sale pertaining to the dwelling was not.

> activity (i.e. the payment and receipt of principal and interest over the 17 to 19 year term of the Agreements of Sale) which takes place between non-domiciliary borrowers and a non-domiciliary lender entirely outside of the State of Hawaii?

It is submitted that the answer by this court to the taxpayer's question in the instant case raises great uncertainty as to the state of the law. Since one of the main purposes of judicial opinions to clarify the law, it is respectfully requested that the instant case be reheard with respect to the following matters:

> First, is the holding of *Hawaiian Beaches, Inc. v. Kondo,* supra, that interest income can only come from the lending of money and not from the sale of any commodity still good law? The rationale in the instant case runs directly contrary to this proposition and it can be reasonably assumed that the ruling regarding the nature of interest income of *Hawaiian Beaches, Inc. v. Kondo, supra,* has been over-ruled by implication. If, indeed, the law of Hawaii has been changed so that interest income can now arise from the activity of selling commodities, both taxpayers and tax practitioners should be so advised. For if the generation of interest income can be said as a matter of law to arise from the activity of selling commodities, then the taxpayers ought to have the opportunity to reargue the proposition that interest incomes from the sale of land in fee simple is part of the "gross proceeds" of such sale and thereby exempt from excise taxation under HRS §237-3.
>
> Second, and more importantly, the holding in the instant case impliedly overrules *Hawaiian Beaches, Inc. v. Kondo, supra,* by holding that the activity of selling of fee simple land and extension of credit to finance the sale do not constitute separate sales and lending activity but constitute a

single unified sales activity for the purpose of the Hawaii General Excise Tax. If the conceptual approach of dividing economic activity into its component parts, here, the activity of selling land in fee simple and the extension of creditor to finance the sale, is no longer valid, then the holding of *Hawaiian Beaches, Inc. v. Kondo, supra,* must be reexamined. For if this court has determined as a matter of law that the two component activities are in fact and in law a single unified activity and that single unified activity is characterized as a land selling activity, then the scope of the exemption for the "gross proceeds of the sale of land in fee simple" must be reexamined.

CONCLUSION

The opinion in the instant case impliedly overrules the two major grounds for the decision in *Hawaiian Beaches, supra,* while retaining the holding of that case as good law. It is respectfully submitted that the matter be reheard and that further opinion be rendered on the points raised herein. Such further exposition and clarification would clearly benefit taxpayer, tax professionals and administrators working within the excise tax system.

DATED: Honolulu, Hawaii, January 24, 1977.

Respectfully submitted,

/s/ JOHN P. GILLMOR
JOHN P. GILLMOR

Attorney for Taxpayers,
Appellants

CERTIFICATE OF COUNSEL

I hereby certify that the foregoing petition is submitted in food faith and not for purposes of delay.
DATED at Honolulu, Hawaii, January 24, 1977.

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[Certificate of Service Omitted]

**IN THE SUPREME COURT OF
THE STATE OF HAWAII**

OCTOBER TERM 1976

In the Matter of the Tax Appeal of GRAYCO LAND ESCROW, LTD. and HAWAIIAN RANCHOS, INC., dba KBSF LAND CO., INC., Taxpayers

NO. 5846

PETITION FOR REHEARING

FEBRUARY 1, 1977

RICHARDSON, C.J., KOBAYASHI, OGATA, MEMOR AND KIDWELL, JJ.

Per Curiam. The petition for rehearing is denied without argument.

/s/ William S. Richardson
/s/ Bert T. Kobayashi
/s/ Thomas S. Ogata
/s/ Benjamin Menor
/s/ H.B. Kidwell

John P. Gillmor (Case, Kay,
Clause & Lynch of counsel)
for the petition.

NO. 5846

**IN THE SUPREME COURT OF
THE STATE OF HAWAII**

OCTOBER TERM – 1976

In the Matter of the Tax Appeal of GRAYCO LAND ESCROW, LTD., and HAWAIIAN RANCHOS, INC., dba KBSF LAND CO., INC., Taxpayers.	CASE NO. 1460 APPEAL FROM JUDGMENT AND ORDER DENYING MOTION TO AMEND FINDINGS OF FACT AND CONCLUSIONS OF LAW TAX APPEAL COURT HON. YASUTAKA FUKUSHIMA JUDGE

JUDGMENT ON APPEAL

Pursuant to the Opinion of the Supreme Court rendered herein on January 14, 1977, the judgment of the lower court is affirmed.

DATED: Honolulu, Hawaii, FEB 4 1977.

BY THE COURT:

/s/ Clement J.H. Chun
Clerk

APPROVED:

/s/ Bert T. Kobayashi [seal]
Justice

Supreme Court, U. S.
FILED
JUN 6 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term 1976

No. 76-1538

GRAYCO LAND ESCROW, LTD. and
HAWAIIAN RANCHOS, INC., dba
KBSF LAND CO., INC.,

Petitioners,

v.

GORDON Y.H. WONG, Director of
Taxation, State of Hawaii, and
STATE OF HAWAII,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF HAWAII

BRIEF FOR RESPONDENTS IN OPPOSITION

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IN THE

Supreme Court of the United States

October Term 1976

No. 76-1538

GRAYCO LAND ESCROW, LTD. and
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v.

GORDON Y.H. WONG, Director of
Taxation, State of Hawaii, and
STATE OF HAWAII,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF HAWAII

BRIEF FOR RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the Supreme Court of the State of Hawaii is reported at 57 Haw. ___, 559 P.2d 264 (1977). The Findings of Fact and Conclusions of Law and the Judgment of the Tax Appeal Court of the State of Hawaii appear in the Appendix to the Petition at pages 4a and 20a.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition.

QUESTION PRESENTED

Whether the Hawaii Supreme Court's decision that Grayco Land Escrow, Ltd. (Grayco), a domiciliary of California, who has subdivided and sold its lands in Hawaii under agreements of sale, is engaged in business in Hawaii and subject to its general excise tax, measured by its interest income received from 1,179 agreements of sale, is in accord with applicable decisions of this court.

STATUTES INVOLVED

§237-13 *Imposition of tax.* There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross

income, whichever is specified, as follows:

* * *

(10) Tax on other business. Upon every person engaging or continuing within the State in any business, trade, activity, occupation, or calling not included in the preceding paragraphs or any other provisions of this chapter, there is likewise hereby levied and shall be assessed and collected, a tax equal to four per cent of the gross income thereof. In addition, the rate prescribed by this paragraph shall apply to a business taxable under one or more of the preceding paragraphs or other provisions of this chapter, as to any gross income thereof not taxed thereunder as gross income or gross proceeds of sales or by taxing an equivalent value of products, unless specifically exempted.

§237-2 *"Business," "engaging" in business, defined.* "Business" as used in this chapter, includes all activities (personal, professional, or corporate), engaged in or caused to be engaged in with the object of gain or economic benefit either direct or indirect, but does not include casual sales.

The term "engaging" as used in this chapter with reference to engaging or continuing in business also includes the exercise of corporate or franchise powers.

§237-3 *"Gross income," "gross proceeds of sale," defined.* "Gross income" means the gross receipts, cash or accrued, of the taxpayer received as compensation for personal services and the gross receipts of the taxpayer derived from trade, business, commerce, or sales and the value proceeding or accruing from the sale of tangible personal property, or service, or both, and all receipts, actual or accrued as hereinafter provided, by reason of the

investment of the capital of the business engaged in, including interest, discount, rentals, royalties, fees, or other emoluments however designated and without any deductions on account of the cost of property sold, the cost of materials used, labor cost, taxes, royalties, interest, or discount paid or any other expenses whatsoever. . . .

* * *

The words "gross income" and "gross proceeds of sales" shall not be construed to include: gross receipts from the sale of bonds or other evidence of indebtedness or stocks or, except as otherwise provided, from the sale of land in fee simple, improved or unimproved, dividends as defined by chapter 235; cash discounts allowed and taken on sales; the proceeds of sale of goods, wares, or merchandise returned by customers when the sale price is refunded either in cash or by credit; or the sale price of any article accepted as part payment on any new article sold, if the full sale price of the new article is included in the "gross income" or "gross proceeds of sales." . . .

STATEMENT OF THE CASE

Petitioner Grayco, trustee and owner in fee simple of 4002.2916 acres of land situated at Kau, County and State of Hawaii, is a California corporation having its principal place of business at Pasadena, California. It is registered to do business in Hawaii, but it has no employees or place of business in-state.

These lands were conveyed undeveloped and in fee simple to Grayco, Trustee, by Hawaiian Ranchos, Inc. dba KBSF Land Co., Inc. (referred to as Hawaiian Ranchos in the Petition and KBSF herein) by Deed dated June 27, 1969

and recorded in the Hawaii Bureau of Conveyances in Liber 6604, Page 242.

Subsequently, the lands were subdivided into 1229 three-acre lots and the subdivision plans were recorded in the Hawaii Bureau of Conveyances; utilities were installed and streets and roads were laid out. The subdivision and improvements were in compliance with ordinances and regulations of the County of Hawaii.

R.J. Beaumont and Associates, a California corporation, whose principal place of business is Beverly Hills, California, was exclusive real estate broker in the sale of Grayco's Hawaii property. Advertisements offering the lots for sale were made through newspapers, radio and television in Hawaii and California and through the United States mail.

Beaumont engaged subagents, who were licensed Hawaii real estate salesmen, to contact prospective purchasers in Hawaii.

When a lot is sold, Grayco, as vendor, and the vendee execute a standard form agreement of sale, which provides for installment payment of the purchase price, including interest on the unpaid principal balance. When all installments are received by Grayco in Pasadena, Grayco issues a deed, mails it to the Hawaii Bureau of Conveyances for recordation and thereafter mails the purchaser a copy. If the purchaser requests title insurance, the deed is sent to Title Guaranty of Hawaii for processing. Of the 1229 lots, 1179 were sold by Grayco on agreements of sale.

The installment moneys received by Grayco are disbursed to beneficiaries, who are all parties to and pursuant to an unrecorded trust agreement, known as Subdivision Agreement No. 152, dated June 24, 1969, which was entered into by Commonwealth United

Corporation, KBSF and Grayco; it was subsequently amended to add Beaumont and again amended to include Dow Banking Corporation.

Commonwealth United Corporation financed the purchase of the land and initial subdivision improvements and held a mortgage on the property. Exeter Equities, a Massachusetts limited partnership, and Dow Banking Corporation, a Swiss corporation, subsequently also advanced funds for the purchase or subdivision improvements.

Purchasers in California were offered an "Aloha Bonus Plan" which gave a $400 credit to each vendee traveling to Hawaii to view the lot with a sales subagent of Beaumont as guide.

The Director of Taxation, State of Hawaii, assessed Grayco gross receipts taxes, penalties and interest on the interest income received from these agreements of sale.

The Tax Appeal Court of the State of Hawaii found that Grayco is engaged in business in Hawaii, that Grayco was not engaged in interstate commerce and, even if interstate commerce were involved, the assessment measured by interest income derived from agreements of sale of land situated in Hawaii was valid. The Hawaii Supreme Court affirmed.

ARGUMENT

I. Grayco Is Doing Business In-State. The Receipts Were From Sources In-State.

A privilege tax is imposed by the State of Hawaii on all persons doing business and other activities in the State. §237-13, Hawaii Revised Statutes.

All businesses in-state, even if the businesses are not enumerated in the statute, are subject to the tax. §237-13(10), Hawaii Revised Statutes.

"Business" is defined in the general excise tax law to mean all activities engaged in for gain or economic benefit either direct or indirect, except casual sales. §237-2, Hawaii Revised Statutes.

The tax is measured by applying rates against values of property, gross proceeds of sales or gross income. §237-13, Hawaii Revised Statutes. "Gross income" is defined to include "all receipts . . . by reason of the investment of the capital of the business engaged in, including interest. . . ." §237-3, Hawaii Revised Statutes.

The argument that the Hawaii Supreme Court characterized interstate financing as in-state in nature through distortion of facts and creating a fiction is without basis. There is no distortion of facts or fiction. Grayco subdivided 4002.2916 acres of its lands in Hawaii into 1229 lots and sold all of them; 1179 were sold in installments under agreements of sale. The Tax Appeal Court and Hawaii Supreme Court found that the interest income was derived from installment contracts of the sale of land in Hawaii. It was therefore from sources within the state and taxable.

Indiana has jurisdiction to impose its gross receipts tax on principal and interest income received by a nonresident under installment sales contracts for Indiana property notwithstanding taxpayer's argument that the taxable situs of the contracts of sale was outside Indiana. *Gross Income Tax Division et al. v. Bartlett*, 228 Ind. 505, 93 N.E.2d 174 (1950), appeal dismissed 340 U.S. 925 (1951). The court held that receipt of income from the sale of lots within the state was derived from sources within the state.

In an earlier decision, the Hawaii Supreme Court held that interest income of a domiciliary from installment sales of land situated in Hawaii is taxable business activity notwithstanding the contracts were executed out-of-state and payments of installments were made out-of-state. *Hawaiian Beaches, Inc. v. Kondo,* 52 Haw. 279, 474 P.2d 538 (1970). The court held that, under the statute, the selling price is exempt, but the interest income from agreements of sale of Hawaii property is taxable.

Petitioner's argument that *Hawaiian Beaches, Inc. v. Kondo, supra,* held interest income comes from the activity of lending money is without basis. The Hawaii Supreme Court refuted this interpretation. Appendix to Petition, page 21a.

Interest income received from installment sales of real estate was taxable as a part of the gross income of the "business of subdividing and selling real estate." The selling price under the Washington statute was exempt from the tax. *Clifford v. State,* 469 P.2d 549 (1970). The court found there is a distinction between a loan based on advancement of money and relinquishing the right to immediate payment.

II. The Tax Is Not A Tax On Interstate Commerce.

The lands owned by Grayco are located in Hawaii and the sources of the income are in Hawaii.

The contracts between citizens of different states are not in interstate commerce where the performance of the contract is to be completed and carried out wholly within the borders of the state. *Western Live Stock v. Bureau of Revenue,* 303 U.S. 250 (1938); *Department of Treasury v. Ingraham-Richardson Mfg. Co.,* 313 U.S. 252 (1941);

Department of Treasury v. Wood Preserving Corp., 313 U.S. 62 (1941); *Gross Income Tax Division v. Bartlett, supra.*

Proceeds of sale of a membership in the New York Stock Exchange by a nonresident were subject to taxation by New York State on the ground that the right to conduct transactions at the exchange and its very nature localizes it at the exchange. *New York ex rel. Whitney v. Graves,* 299 U.S. 366 (1937).

Domiciliaries of the State are subject to the same tax. The tax is nondiscriminatory. *McGoldrick v. Berwind-White Coal Mining Co.,* 309 U.S. 33 (1940).

J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938), wherein the gross receipts tax based on sales in other states was invalidated on commerce clause grounds, is distinguishable. Movable goods manufactured in Indiana were involved there as distinguished from the present case in which the property has a permanent situs in Hawaii. This court significantly held in *J.D. Adams Mfg. Co. v. Storen, supra,* that, if the tax is on the "privilege" of doing local business measured by gross sales, the measurement of the tax can include interstate as well as local sales assuming there is some local business.

Gwin, White & Prince v. Henneford, 305 U.S. 434 (1939), is also distinguishable. Fruits were shipped from Washington State and were moving in commerce between the states; in our case the land is situated in Hawaii permanently. It was recognized in *Gwin, supra,* that even interstate commerce must pay its way and that not every local tax measured upon gross income from interstate commerce is forbidden. In the present case local business must also pay the same tax on its interest income from deferred payments on sales of land. *Hawaiian Beaches, Inc.*

v. Kondo, supra. There is no discrimination against foreign corporations.

Norfolk v. Western R. Co. v. Missouri Tax Commission, 390 U.S. 317 (1968), and *Central Greyhound Lines v. Mealey,* 334 U.S. 653 (1948), are not applicable because the taxpayers were transportation companies as compared with in-state activity of selling land located in-state.

American Oil Co. v. Neill, 380 U.S. 451 (1965), is also inapplicable. The sale of motor fuel was there made out-of-state after which it arrived in-state.

The case of *Cleveland, Painesville and Ashtabula R.R. Co. v. Pennsylvania,* 82 U.S. (15 Wall.) 300 (1873), is inapplicable because bonds of the corporation owned by nonresidents were involved. In the present case, the activity is the owning, subdividing and selling lands in Hawaii under installment sales contracts. There is a distinction between the two transactions.

III. The Tax Does Not Burden Interstate Commerce.

Petitioner has not shown in what manner interestate commerce is burdened. Since the tax is on contracts of sale of land within the State, there is no possibility of a similar tax on the same transaction by another state. *Gross Income Tax Division v. Bartlett, supra.*

The Tax Appeal Court and Hawaii Supreme Court found that the Petitioner received local benefits such as the privilege of operating a business, and the use of roads, streets, laws, ordinances, recording system and the courts in the conduct of its business. *Wisconsin v. J.C. Penney & Co.*, 311 U.S. 435 (1940); *General Motors Corp. v. Washington*, 377 U.S. 436 (1964).

The tax on unapportioned gross receipts was sustained if the State has exerted its power in proportion to the taxpayer's activities within the State and to its consequent enjoyment of the opportunities and protections which the State has afforded. *General Motors Corp. v. Washington, supra*; *Standard Pressed Steel Co. v. Department of Revenue of Washington*, 419 U.S. 560 (1975).

Radio broadcasting within the state was held sufficient in-state activity to sustain the tax. *McCaw & Keating v. Tax Commissioner, Fase*, 40 Haw. 121 (1953), aff'd. 216 F.2d 700, cert. denied, 348 U.S. 927 (1955).

Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931), involved apportionment formulas of a foreign corporation whose sources of income were derived from different states. The case is inapplicable here, because the source of Grayco's income is the land located in Hawaii.

Grain sold and moving in interstate commerce was involved in *Dahnke-Walker Co. v. Bondurant*, 257 U.S. 282 (1921). Under recent cases, even interstate commerce must pay its way. *Complete Auto Transit Inc. v. Brady*, decided in the United States Supreme Court March 7, 1977.

The holding in *Fisher's Blend Station v. Tax Commission of the State of Washington,* 297 U.S. 650 (1936) that radio broadcasting is interstate commerce is not applicable here where the income is from lands in Hawaii which are sources within the State of Hawaii.

CONCLUSION

For the reasons stated above, Respondents request that a Petition for a Writ of Certiorari should be denied.

Dated: Honolulu, Hawaii, June 3, 1977.

Respectfully submitted,

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I hereby certify that a copy of this Brief In Opposition was served upon John P. Gilmor, Attorney for Petitioners, by mailing the same to him at his office at 1100 First Hawaiian Bank Bldg., Honolulu, Hawaii 96813 this date.

Honolulu, Hawaii, June 3, 1977.

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